SUTHERLAND

LEGAL ALERT

January 6, 2010

IRS Rules on Annuity Issues in Defined Contribution Plans

In a preface to the 2010 policy discussion about enhancing income security in defined contribution plans, the Internal Revenue Service ruled in PLR 200951039 (Sept. 21, 2009), on several issues under current law related to the use of annuity contracts in these plans.

Facts

The ruling request, which was pending since 2005, posited the following facts:

- A defined contribution plan, qualified under Internal Revenue Code ("IRC") § 401(a), holds a group annuity contract (or, where the group contract has been discontinued as a designated option under the plan, an individual contract) that is used to offer an annuity distribution option to participants. That distribution option is mirrored in the provisions of the plan.
- Both before and after a participant's election of the annuity distribution option, the contract makes available both fixed and variable (ultimately, mutual fund) investment options to which participants can allocate their accounts.
- The annuity distribution option provides for an income payment stream for the participant's life (or the joint life of the participant and a designated beneficiary) in two phases.
- Phase I essentially is a series of periodic withdrawals, for five years up to a designated maximum period as the participant elects.
- The initial periodic payment is the product of the participant's account value on the start date and an annuity factor based on (i) the age and sex of the participant, and (ii) the assumed interest rate, payment frequency and payment period (within specified ranges) selected by the participant.
- The amount of the payment thereafter is adjusted for the net performance of the investment options selected by the participant in relation to the assumed interest rate.
- During Phase I, the participant may, subject to certain restrictions and procedures, (i) allocate additional plan contributions or transfer other plan balances to the contract, (ii) surrender his or her interest in the contract in full, (iii) direct the insurance company to stop or restart payments, or (iv) change the joint annuitant (if any), the payment period, the periodic payment pattern, or the assumed interest rate.
- On the participant's death, the account value is available as a death benefit.
- Phase I is treated for state insurance law purposes as a deferred annuity.
- At the end of Phase I, the contract provides for the commencement of Phase II. During this phase, life contingent annuity payments are made in a predetermined periodicity and amount (other than ongoing adjustments for actual investment performance) for the life of the participant

© 2010 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

and continue even if the account value is exhausted. The participant may no longer exercise the Phase I rights noted above. Payments are continued after the participant's death in accordance with the form of the annuity and death benefit option elected by the participant (subject to IRC § 401(a)(9)). Phase II is treated for state insurance regulatory purposes as a payout annuity.

Rulings

Based on those facts and several representations made by the insurance company, the IRS issued the following rulings under §§ 401(a)(9), 401(a)(11) and 417. While the IRS does not ordinarily issue rulings on plan qualification issues outside the plan determination letter process – with the result that public guidance on qualification issues is generally limited to regulations and published rulings – its procedures do allow for such rulings where (i) the qualification issue involved is unique and requires immediate guidance, (ii) as a practical matter, it is not likely that such issue will be addressed through the determination letter process, and (iii) it is in the interest of good tax administration for the IRS to provide guidance with respect to the qualification issue.

Required Minimum Distributions. The § 401(a)(9) regulations provide "account rules" that generally apply to the determination of required minimum distributions ("RMD") from defined contribution plans (Treas. Reg. § 1.401(a)(9)-5), subject to "annuity rules" that control to the extent that the participant's account balance is "annuitized" (Treas. Reg. § 1.401(a)(6)-6). The IRS had not previously addressed when a contract is "annuitized" for these purposes. Relying on the definition of "amounts received as an annuity" under Treas. Reg. § 1.72-2 and the state law treatment of the contract, the IRS ruled that:

- During Phase I, the contract is not "annuitized" because the participant has control over the amount and timing of payments; and

- During Phase II, the contract is "annuitized" because the payments become "fixed," notwithstanding the ongoing adjustments for investment performance.

Election of a Life Annuity. The plan relies on the profit-sharing plan exception in IRC § 401(a)(11)(B)(iii), with the result that spousal consent to a payment form other than a qualified joint and survivor annuity ("QJSA") is not required unless and until a participant elects "benefits in the form of a life annuity." On this point, the IRS observed that, under the contract, the participant elects the annuity distribution option at the start of Phase I and does not necessarily make a second election prior to the start of Phase II. Given that structure, the IRS characterized the initial election of the annuity distribution option as an election to receive a future benefit in the form of a life annuity (apparently, Phase II payments), preceded by a distribution not in the form of a life annuity (apparently, Phase I payments). Accordingly, the IRS ruled that § 401(a)(11) applies at the time the participant elects the annuity distribution option, as distinguished from the election to receive Phase I payments or (as the taxpayer urged) Phase II payments.

- The logic of the ruling is that only Phase II payments constitute "benefits in the form of a life annuity" subject to the spousal consent requirements. (There is no express discussion of the characterization of the Phase II benefits in this section of the ruling letter.)

- Treas. Reg. § 1.401(a)-20, Q&A-4 provides, however, that once a life annuity option is elected, the survivor annuity requirements of § 401(a)(11) and § 417 apply to all of the participant's benefits unless there is a separate accounting of the account balance subject to the election.

© 2010 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

SUTHERLAND

- To the extent such a separate accounting is provided, the practical import of the ruling is that the plan must satisfy the applicable written explanation, consent, election and withdrawal rules of § 417, including waiver of the QJSA:
    - Only with respect to Phase II payments, with the result that the participant could modify payments during Phase I without spousal consent so long as the Phase II life annuity payments are not modified or reduced; and
    - Within 180 days of the “annuity starting date,” which is defined in § 417(f). While the ruling on the § 401(a)(11) issue does not address this point, the ruling on the RMD issue suggests that the annuity starting date may coincide with the start of Phase II payments.

QJSA. Consistent with the structure of variable payout annuities generally, the contract determines Phase II payments, to the extent measured by the variable investment options under the contract (rather than the fixed option), on the basis of “annuity units” that vary in value with the performance of the investment option. The IRS agreed with the taxpayer that a QJSA could be based on a specified percentage of the annuity units used to calculate payments during the joint lives of the participant and the spouse, rather than of the dollar amount payable during that period.

Next Steps

There will be a second ruling letter on these facts, separately addressing certain issues under the insurance tax provisions of the IRC.

More generally, this ruling is indicative of the legal complexities that can arise when defined contribution plans seek to enhance the retirement income security of their participants through the use of annuity contracts. The IRS Business Plan guidance project on lifetime income from defined contribution plans, scheduled by the IRS as part of its joint initiative with the Department of Labor to facilitate annuitization in defined contribution plans, seems likely to consider issues such as those addressed in this ruling. The broader policy question – whether present law is optimally structured to permit lifetime income solutions in defined contribution plans – will form part of the retirement policy discussion continuing in the executive and legislative branches.

If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Daniel M. Buchner	202.383.0869	daniel.buchner@sutherland.com
Adam B. Cohen	202.383.0167	adam.cohen@sutherland.com
Jamey A. Medlin	404.853.8198	jamey.medlin@sutherland.com
Alice Murtos	404.853.8410	alice.murtos@sutherland.com
Joanna G. Myers	202.383.0237	joanna.myers@sutherland.com
Robert J. Neis	404.853.8270	robert.neis@sutherland.com
Vanessa A. Scott	202.383.0215	vanessa.scott@sutherland.com
W. Mark Smith	202.383.0221	mark.smith@sutherland.com
William J. Walderman	202.383.0243	william.walderman@sutherland.com
Carol A. Weiser	202.383.0728	carol.weiser@sutherland.com

© 2010 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.