



# PLAN SPONSOR UPDATE

## Lifetime income: current policy initiatives

Defined contribution plans, as account-based plans, in which nearly all retirement savings risk is borne by the participant, present (broadly) three “adequacy” challenges: (1) adequate savings; (2) adequate investment; and (3) adequate payout. Tools have been developed, over several decades, to address challenges (1) and (2), generally through the use of defaults, savings incentives, and fiduciary practice (e.g., in fund menu design). There has been less success developing solutions to challenge (3) – translating the DC account into a stream of retirement income that will last over the participant’s (generally uncertain) expected life.

### Obstacles to lifetime income solutions

*DC plans are generally designed to pay out lump sums:* To begin with, as account-based plans, the “intuitive” form of payment of a DC benefit is a lump sum equal to the account balance. Further, payment of a lump sum comports with the 401(k) system’s general bias towards devolving as much decision-making as possible to participants.

*Internal Revenue Code rules:* Qualified joint and survivor annuity (QJSA) rules generally require that benefits under a tax-qualified retirement plan be paid in the form of a qualified (spousal) joint and survivor annuity, unless the participant elects a different form with the (notarized) consent of the participant’s spouse. This rule does not (with limited exceptions) apply to a DC plan where (1) the participant’s benefit is payable on the participant’s death to the participant’s spouse and (2) the participant does not elect payment in the form of a life annuity.

The result is that most 401(k) plans, other than those marketed by annuity carriers, simply provide for payment on termination of employment in the form of a lump sum with, perhaps, an option to have payment over a period of years (e.g., over the participant’s life expectancy).

*Fiduciary risk:* There remains widespread concern that sponsor fiduciaries may be held responsible, perhaps for decades, for the financial viability of any annuity carrier selected to offer an annuity under the plan.

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March 2019

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### SUMMARY

In this article we consider the obstacles to finding a DC “lifetime income solution” and then survey the (limited) policy initiatives that have thus far been adopted or proposed to address the DC/401(k) payout challenge.

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In 2008 DOL finalized a regulation providing a safe harbor for the purchase of annuities in a DC plan. While that rule improved on DOL's "safest available annuity" standard, it still imposed significant duties on plan fiduciaries, including that the fiduciary appropriately conclude that "at the time of the selection, the annuity provider is financially able to make all future payments."

*Individual bias against annuities:* The consensus among sponsors and providers is that participants are significantly biased against selecting annuities and in favor of taking lump sums. Many different reasons have been given for this, including: (1) the human bias in favor of present consumption over future security (aka hyperbolic discounting); (2) the complexity of annuities as a product; and (3) inefficiencies in the annuity market. In addition, we would note at least two other factors. *First*, Social Security, which is paid as an annuity, represents a significant portion of the retirement benefits for lower paid employees. And *second*, research shows that uncertainty, e.g., about life expectancy and possible future spending needs, plays a significant role in participants not electing annuity payouts.

*The heterogeneity of needs and preferences in retirement:* Finally, and perhaps most problematic, is the heterogeneity of individual needs and preferences in retirement. Some participants may (realistically) see themselves as likely "losers" in the annuity tontine – compromised health (for instance) may make them likely to die before their "average life expectancy" date. In addition, a participant might also anticipate significant, unpredictable one-time expenses.

### **Policy initiatives to encourage in-plan annuities**

*QLACs:* On July 1, 2014 IRS released its final regulation on longevity annuities, generally providing a limited exception to the required minimum distribution (RMD) rules for qualifying longevity annuity contracts (QLACs), generally defined as insurance company annuities the premiums for which do not exceed the lesser of \$125,000 or 25% of the employee's account balance.

- There are proposals in Congress to expand the QLAC RMD exemption, e.g., the Portman-Cardin proposal to eliminate the 25% of the account balance limit and increase the dollar limit to \$200,000 and to allow a "free look period" and certain variable and indexed annuity contracts to qualify as QLACs.

*Rev. Rul. 2012-3 clarifying the application of QJSA rules to 401(k) plans offering annuities as investment options:* This revenue ruling holds that the QJSA rules (described above) do not apply until annuitization where,

under an annuity investment option in a DC plan, the participant can transfer assets out of the annuity contract at any time before annuitization.

*Rev. Rul. 2012-4 providing a “roadmap” for certain DC to DB rollovers:* This revenue ruling generally provides a compliance roadmap for DC to DB rollovers.

*Annuity fiduciary safe harbor:* Several proposals have been introduced in Congress, including the Retirement Enhancement and Savings Act (RESA), to expand the fiduciary safe harbor for the inclusion of an annuity purchase option in a DC plan. Generally, these proposals address the issue by deferring to state insurance regulation on the issue of the financial condition of the annuity carrier.

*Lifetime income disclosure:* While DOL has not moved forward on its project to adopt rules for defined contribution plan benefit statements that would require inclusion of disclosure of an estimated lifetime stream of payments. There have, however, been a number of lifetime income disclosure proposals (e.g., in RESA) introduced in Congress.

*Annuity portability:* There are a number of Congressional proposals to facilitate the portability of lifetime income options (generally, annuities), e.g., Congressman Neal’s (D-MA and now Chairman of the House Ways and Means Committee) Automatic Retirement Plan Act of 2017.

*ERISA Advisory Council Lifetime Income Recommendations:* The 2018 ERISA Advisory Council recommended that DOL modify current QDIA regulations to allow the inclusion of annuities and other lifetime income options in QDIAs and allow outsourcing of fiduciary obligations with respect to the selection and management of lifetime income options.

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We will continue to follow this issue.

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As an increasing number of American workers are retiring with DC account balances, concern about the adequacy of DC/401(k) payout options and strategies has significantly increased, among policymakers, sponsors and providers.

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