

## Tax guidance on lifetime income options

By Marcia S. Wagner, Esq.

A recent package of guidance from the IRS will make it easier for retirees to choose to receive their benefits as a stream of income for as long as they live by reducing the regulatory burdens associated with annuity distribution options. This regulatory action is a first step in the enhancement of flexible “lifetime income” options.

On February 2, 2012, the IRS issued four different sets of guidance concerning lifetime income options for defined contributions plans (“DC Plans”). This guidance, which also has implications for individual retirement accounts (“IRAs”) and defined benefit plans (“DB Plans”), is described below.

*Proposed Regulations on Partial Annuity Distribution Options for DB Plans.* These proposed regulations would encourage DB Plan sponsors to offer “split options,” where participants may elect to receive a portion of their accrued benefits as an annuity and the other portion as a lump sum.

Under current law, if a plan were to offer split options to participants, statutory actuarial assumptions would generally need to be used to calculate each bifurcated benefit (i.e., partial lump sum and partial annuity). However, as proposed, plans would only be required to use the statutory assumptions to calculate the partial lump sum, meaning that the plan’s regular conversion factors would be used to calculate the partial annuity.

For example, let us assume that a newly retired participant (age 62) has accrued a normal retirement benefit of \$1,350 per month (payable at age 65). Let us further assume that this benefit either has an *immediate* monthly annuity value of \$1,200 (determined using the plan’s regular conversion assumptions), or an immediate lump sum value of \$100,000 (determined using statutory assumptions). If the participant were to elect 25% of his benefit as an annuity (and the remaining 75% as a lump sum), under the proposed regulations, the participant would be entitled to a \$300 immediate monthly annuity and a \$75,000 current lump sum. As illustrated, the proposed regulations would allow the plan to use simple arithmetic ( $25\% \times \$1,200$ ) to arrive at the value of the partial annuity. Conversely, a much more complex calculation would be required under the current rules.

*Proposed Regulations on Longevity Annuity Options for DC Plans and IRAs.* A longevity annuity is sometimes referred to as “longevity insurance” or a “deeply deferred annuity.” It is an annuity with an income stream that begins at an advanced age, such as age 80. As the name suggests, longevity annuities are a very effective tool to manage longevity risk. These types of annuities are especially attractive to investors who believe they will be able to manage the rest of their savings until age 80, or the applicable commencement date of the longevity annuity.

However, under current law, longevity annuities are not an attractive investment vehicle because of the required

minimum distribution (“RMD”) rules, which require distributions to commence at age 70½. Under the proposed regulations, any portion of a plan or IRA account invested in a qualifying longevity annuity contract (“QLAC”) would be disregarded for purposes of the RMD rules. For example, if participants allocated a portion of their accounts to a QLAC at age 70 (or in increments over time before age 70), only the nonannuity portion of their accounts would be subject to the RMD rules. To qualify as a QLAC, the annuity premium must be limited to the lesser of \$100,000 or 25% of the account balance. In addition, the QLAC must commence annuity payments no later than age 85.

*Revenue Ruling 2012-3 on Spousal Consent Rules for DC Plans.* Prior to this guidance, there was some uncertainty with regard to how the spousal consent rules would apply in the case of a DC Plan with deferred annuity investments. Most DC Plans are exempt from the spousal consent requirement (e.g., a participant does not need spousal consent to take an immediate lump sum), because they provide that the participant’s account is payable to his or her surviving spouse upon death and meet certain other related conditions.

However, if such a DC Plan were to offer an annuity option and a participant were to affirmatively elect it, the spousal consent requirements would apply. One of the applicable requirements is that, without spousal consent, the participant’s account must be paid in the form of a qualified pre-retirement survivor annuity (“QPSA”) upon the participant’s death to the surviving spouse. In Revenue Ruling 2012-3, the IRS clarified that when a participant invests in a deferred annuity under a DC Plan, the participant’s account is not subject to the QPSA requirement before the participant affirmatively elects to commence an immediate annuity distribution.

*Revenue Ruling 2012-4 on Rollovers from DC Plans to DB Plans.* This guidance benefits employers that sponsor both a DB Plan and a DC Plan, as well as the participants in both plans who prefer lifetime income options. Under Revenue Ruling 2012-4, as an alternative to offering annuity options under the DC Plan, an employer may amend its DB Plan to permit rollovers to it from the DC Plan. Accordingly, a participant who desires to annuitize his or her DC Plan account balance may do so by rolling over his or her account balance to the DB Plan and receiving an actuarial equivalent annuity benefit payable from the DB Plan.

The advantage of this type of arrangement is that the participant is able to benefit from the favorable actuarial assumptions used in the DB Plan (rather than the prevailing actuarial assumptions utilized for individual annuity contracts in the commercial marketplace). ❖

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Marcia S. Wagner is the Managing Director of The Wagner Law Group and can be reached at or at [Marcia@WagnerLawGroup.com](mailto:Marcia@WagnerLawGroup.com).