VOL. 45, NO. 2 AUTUMN 2019

Employee Relations
LAW JOURNAL

Employee Benefits

It's Time to Start Talking About Annuities in 401(k) Plans

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When an employee retires, he or she typically has three sources of income to draw upon: personal savings, Social Security, and a retirement plan (typically a 401(k) plan). These income sources are subject to certain risks. There is "longevity risk," *i.e.*, the risk that the retiree will outlive his or her savings. There is also "inflation risk," *i.e.*, the risk that the retiree's purchasing power will erode over time. There is also an "incapacity risk," *i.e.*, the risk that the retiree will have a diminishing capacity to oversee his or her investments as he or she ages.

Annuities can help solve several of these issues because they provide benefits over a retiree's lifetime. As a result, some employers are adding annuities to their 401(k) plan.[1] Congress is also encouraging 401(k) plan sponsors to offer in-plan annuities. Proposed bipartisan legislation alleviates many concerns that 401(k) plan sponsors have about offering annuities within their plans. This legislation is expected to be enacted into law later this year. As in-plan annuities solve important retirement issues and are far less expensive to participants than those available in the retail market, plan sponsors may

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wish to consider making in-plan annuities available to their 401(k) plan participants.

Annuities

At its core, an annuity is a contract between an individual and an insurance company to cover specific financial goals, such as principal protection or lifetime income. Usually, an annuity provides a fixed stream of payments to an individual following retirement. There are many types of annuities, but the two main types are fixed annuities and variable annuities. With a fixed annuity, the payments are equal. With a variable annuity the payments can vary depending on such things as investment returns. In either case, the payments are typically made for a set period, *e.g.*, 25 years, or over the life of an individual or over the joint lives of the individual and his or her spouse. Annuities are not for everyone as they typically offer less liquidity and portability. However, plan participants who understand annuities typically believe that they are an important part of retirement planning.[2]

Analyzing Annuities

Most 401(k) plans do not offer in-plan annuities and employers have been hesitant to add them to their plan's investment menu. As a result, the only way for most participants to "annuitize" their 401(k) benefit is to take periodic partial withdrawals from their plan (if their plan allows for this) or rollover their account into an individual retirement annuity that is available in the retail market. There are numerous reasons for why most 401(k) plans do not offer in-plan annuities but they primarily boil down to administrative issues and fiduciary risk. Because annuities have a certain degree of complexity, employers should work with their ERISA counsel and investment consultant to develop a process for analyzing and selecting the annuity.

If it is determined that it is desirable to offer an in-plan annuity, plan fiduciaries should evaluate several annuity products. There are many annuity products in the market place, but the plan's investment advisor can help winnow down the universe to a manageable number of potential candidates. The analysis of the annuity products must be performed in accordance with the Employee Retirement Income Security Act of 1974, as amended (ERISA). Under ERISA, a plan fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[3] This is a very high standard of conduct and requires plan fiduciaries to act like prudent experts.

Another important fiduciary duty under ERISA requires fiduciaries to act for the exclusive purpose of providing retirement benefits to plan participants and to discharge their duties solely in the interest of plan participants. ERISA describes these duties as follows: "A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and: (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries."[4] Thus, a plan fiduciary, when confronted with a decision, must always place the interests of the plan participants ahead of everything else (e.g., their own interests or the plan sponsor's interests). This fiduciary duty is sometimes referred to as the "duty of loyalty."

To comply with the duty of prudence, a plan fiduciary must undertake a thorough investigation of the annuity product. Generally, a thorough investigation will include, among other things, a review of the ratings of the annuity provider, an understanding of how the annuity is invested and how those investments are selected. Because annuities are long term investments, fiduciaries will also need to evaluate whether the annuity provider will have the ability and longevity to provide the benefits over the lifetime of participants. This is often difficult to ascertain. The annuity product should also be examined to determine what happens if the plan sponsor wishes to terminate the annuity contract. In particular, a plan sponsor will want to determine if any charges are involved with terminating the annuity, such as a surrender charge. The plan sponsor will also want to understand the conditions under which participants can liquidate their annuity and move to other investment classes.

The fees and expenses associated with the annuity should also be evaluated. As a general matter, the fees associated with annuities are typically higher than the fees associated with other investment classes such as mutual funds. ERISA requires that fees be reasonable.[5] Fiduciaries, therefore, should at least ascertain, through benchmarking or other investigation, that their annuity product is reasonably priced. There are a variety of fees that may be charged in connection with an annuity. For example, a spousal death benefit can typically be added to an annuity, but at an additional charge.

Plan fiduciaries should also understand how and when the annuity is valued. The valuation of a participant's 401(k) plan account balance is, of course, very important for the operation of the plan. It is necessary, for example, for completion of the plan's Internal Revenue Service Form 5500. It is also necessary for administering such things as participant loans, qualified domestic relations orders, and minimum required distributions. Accordingly, plan fiduciaries should confirm that the annuity can be valued accurately and timely.

Once an annuity product is selected, the plan fiduciary's responsibilities do not end. The plan fiduciaries must monitor the investment on a periodic basis to determine that it remains a prudent selection. Plan fiduciaries must act "under the circumstances then prevailing"[6] which means as facts and circumstances change, a fiduciary must evaluate earlier decisions. Thus, if an alternative annuity proves to be a more prudent choice, the fiduciary should consider terminating the existing contract and moving to the new annuity.

Plan fiduciaries should also ensure that communications to participants regarding the annuity are clear and accurate. Great care should be taken in crafting communications as it may be difficult to describe the annuity's benefits, particularly if each payment in the stream of payments fluctuates.

Legislative Relief

The Treasury Department has been supportive of 401(k) plan annuities and has issued regulations which encourage plan sponsors to offer "qualified longevity annuity contracts" through their 401(k) plan.[7] More importantly, two bills are making their way through Congress which address some of the major concerns that plan sponsors have about annuities. One bill is called the SECURE Act[8] which has already passed the House Ways and Means Committee. In the Senate, the Retirement Enhancement and Savings Act[9] was introduced to the Finance Committee. The bills are very similar and Congressional leadership is eager to have a consolidated bill enacted into law later this year.

The law is very likely to include an "annuity selection safe harbor" which plan sponsors can use to satisfy most of their fiduciary responsibilities. As indicated above, under ERISA, plan fiduciaries have to consider the ability and longevity of the annuity provider before it can offer its products to plan participants. The safe harbor would essentially shift that responsibility to state insurance regulators who would ensure that the annuity providers are adequately capitalized. Monitoring requirements would be satisfied if plan fiduciaries received an annual statement from the annuity provider that the provider is in compliance with state regulations. Fiduciary risk is seen as one of the primary reasons for plan sponsors not offering annuities in their 401(k) plan and the annuity selection safe harbor greatly reduces that risk.

Another barrier to offering annuities in a 401(k) plan has been the question of their portability. Currently, a plan participant who holds an annuity in a 401(k) plan may be left in a difficult position if they leave their employer or if the plan fiduciaries terminate the annuity. Under the proposed legislation, qualified defined contribution plans, as well as Section 403(b) plans and governmental Section 457(b) plans, will be able to make a direct trustee-to-trustee transfer of the annuity to another employer-sponsored retirement plan or IRA. Among other things, this will permit participants to preserve their lifetime income investments and avoid surrender charges and fees.

Conclusion

Annuities are useful for providing retirees with income they cannot outlive and protection against the inability of retirees to manage their money as they age. On balance, they are more expensive than comparable investment products, such as mutual funds, and offer somewhat less flexibility and liquidity. However, for some participants, annuities will be an appropriate retirement income solution. Therefore, 401(k) plan sponsors should consider making in-plan annuities available to participants.

Notes

1. Annuities are currently offered in about 9.3 percent of 401(k) plans according to the Plan Sponsor Council of America.

2. "Participants like in-plan annuities — when they know what they are," Benefitspro.com, June 27, 2016.

3. ERISA §404(a)(1)(B).

4. ERISA §404(a)(1).

5. ERISA §404(a)(1)(A)(ii).

6. ERISA §404(a)(1)(B).

7. Treas. Reg. §1.401(a)(9)-6. A longevity annuity is an income stream—a type of "deferred income annuity"—that begins at an advanced age and continues throughout the individual's life. Treasury regulations make longevity annuities accessible to 401(k)s and other employer-sponsored individual account plans and IRAs by amending the required minimum distribution regulations so that longevity annuity payments will not need to begin prematurely in order to comply with those regulations.

8. H.R.1994 — 116th Congress (2019-2020).

9. S.2526 — 115th Congress (2017-2018).