

Lifetime Income Provided Through Target Date Funds in Section 401(k) Plans and Other Qualified Defined Contribution Plans

I. PURPOSE

This notice provides a special rule that enables qualified defined contribution plans to provide lifetime income by offering, as investment options, a series of target date funds (TDFs) that include deferred annuities among their assets, even if some of the TDFs within the series are available only to older participants. This special rule provides that, if certain conditions are satisfied, a series of TDFs in a defined contribution plan is treated as a single right or feature for purposes of the nondiscrimination requirements of § 401(a)(4) of the Internal Revenue Code. This permits the TDFs to satisfy those nondiscrimination requirements as they apply to rights or features even if one or more of the TDFs considered on its own would not satisfy those requirements.

II. BACKGROUND

Section 401(a)(4) provides in general that a plan is a qualified plan only if the contributions or the benefits provided under the plan do not discriminate in favor of highly compensated employees.

Section 1.401(a)(4)-4 of the Income Tax Regulations provides that optional forms of benefit, ancillary benefits, and other rights and features must be currently available to a group of employees that satisfies the nondiscriminatory classification requirement of § 410(b) (without regard to the average benefit percentage test). In addition, the group of employees to whom these benefits, rights, and features are effectively available must not substantially favor highly compensated employees.

Section 1.401(a)(4)-4(e)(1) provides that the term “optional form of benefit” means a distribution alternative (including the normal form of benefit) that is available under a plan with respect to benefits described in § 411(d)(6)(A) or a distribution alternative that is an early retirement benefit or retirement-type subsidy described in § 411(d)(6)(B)(i), including a “qualified social security supplement” (QSUPP) as defined in § 1.401(a)(4)-12.

Section 1.401(a)(4)-4(e)(2) provides that the term “ancillary benefit” means social security supplements (other than QSUPPs), disability benefits not in excess of a qualified disability benefit described in § 411(a)(9), ancillary life insurance and health insurance benefits, death benefits under a defined contribution plan, preretirement death benefits under a defined benefit plan, shut-down benefits not protected under § 411(d)(6), and other similar benefits.

Section 1.401(a)(4)-4(e)(3)(i) provides that the term “other right or feature” generally means any right or feature applicable to employees under the plan. Different rights or features exist if a right or feature is not available on substantially the same terms as another right or feature. Section 1.401(a)(4)-4(e)(3)(ii) provides that a right or feature is not considered an other right or feature if it is an optional form of benefit or ancillary benefit, or cannot be expected to be of meaningful value to an employee. Section 1.401(a)(4)-4(e)(3)(iii)(C) provides, as an example, that the right to a particular form of investment is an other right or feature.

Section 1.401(a)(4)-1(d) provides that the Commissioner may, in revenue rulings, notices, and other guidance, published in the Internal Revenue Bulletin, provide any additional guidance that may be necessary or appropriate in applying the nondiscrimination requirements of § 401(a)(4), including additional safe harbors and alternative methods and procedures for satisfying those requirements.

Questions have arisen regarding compliance with the nondiscrimination requirements of § 401(a)(4) for an arrangement under which a plan’s investment options include a series of TDFs, some of which hold deferred annuities. Under the arrangement, the TDF series is a group of TDFs managed by an investment manager and each of the TDFs is invested in a manner appropriate for a particular age group, with the mix of equity and fixed income exposure becoming more conservative over time in order to reflect the applicable age group’s advancing age.

Some of the fixed income exposure in the TDFs for older age groups results from the purchase of deferred annuities, which will be distributed to participants when the TDF is dissolved at its target date. As each group’s age advances, an increasing portion of the portfolio is applied to the purchase of deferred annuities. Stakeholders indicate that it would not be actuarially reasonable for an insurer to offer a deferred annuity at a price that does not vary based on the age of the purchaser, and that, accordingly, a TDF that holds deferred annuities should not be expected to permit participants whose ages fall outside the designated age-band for the TDF to hold an interest in that TDF.

If the deferred annuity within a TDF is made available only to older participants, these participants could disproportionately consist of highly compensated employees (because, as a group, older employees are often higher paid than younger employees). If so, making TDFs with deferred annuities available only to older participants presents the question of whether the use of age-restricted TDFs could violate the current availability or effective availability requirement for benefits, rights, and features under § 1.401(a)(4)-4. Stakeholders have requested guidance that the use of a series of TDFs to provide lifetime income in this manner does not violate those nondiscrimination requirements of § 401(a)(4).

III. TREATMENT OF A TDF SERIES AS A SINGLE RIGHT OR FEATURE

The right to each form of investment available under a plan, including each TDF in a series of TDFs, is an other right or feature within the meaning of § 1.401(a)(4)-(4)(e)(3)(iii)(C). Therefore, each TDF must be made available in a nondiscriminatory manner and must otherwise satisfy the nondiscrimination requirements under § 401(a)(4) and § 1.401(a)(4)-4.

Pursuant to the Commissioner's authority under § 1.401(a)(4)-1(d) to provide an alternative method for satisfying the nondiscrimination requirements, a series of TDFs under a defined contribution plan in which participation in some TDFs is restricted to participants in particular age-bands is permitted to be treated as a single "other right or feature" for purposes of § 1.401(a)(4)-4, provided that the following conditions are satisfied:

1. The series of TDFs is designed to serve as a single integrated investment program under which the same investment manager manages each TDF and applies the same generally accepted investment theories across the series of TDFs. Thus, the only difference among the TDFs is the mix of assets selected by the investment manager, which difference results solely from the intent to achieve the level of risk appropriate for the age-band of individuals participating in each TDF. In accordance with the consistent investment strategy used to manage the series of TDFs, the design for the series is for the mix of assets in a TDF currently available for older participants to become available to each younger participant as the asset mix of each TDF for younger participants changes to reflect the increasing age of those participants.
2. Some of the TDFs available to participants in older age-bands include deferred annuities, and none of the deferred annuities provide a guaranteed lifetime withdrawal benefit (GLWB) or guaranteed minimum withdrawal benefit (GMWB) feature.¹
3. The TDFs do not hold employer securities, as described in section 407(d)(1) of the Employee Retirement Income Security Act of 1974, Public Law 93-406, as amended (ERISA), that are not readily tradable on an established securities market.
4. Each TDF in the series is treated in the same manner with respect to rights or features other than the mix of assets. For example, the fees and administrative expenses for each TDF are determined in a consistent manner, and the extent to

¹ Under a contract that provides GLWBs with respect to a participant's account, the participant is guaranteed to receive a specified lifetime stream of income regardless of the investment performance of the account, while still retaining access to the funds in the account. This GLWB feature permits a participant to withdraw annually a certain percentage (for example, 5 percent) of a contractually specified income or benefit base. In the event that the participant's account balance (determined without regard to any potential future GLWB payments) is reduced to \$0 as a result of these guaranteed annual withdrawal amounts, the insurer will continue to pay the guaranteed withdrawal amount annually for the remainder of the participant's life. A GMWB feature is similar to a GLWB feature, but a stream of income is guaranteed for a specified period rather than for the lifetime of the contract owner or annuitant. Treasury and the IRS are considering whether or not to provide guidance related to issues arising from the use of GLWB and GMWB features in defined contribution plans.

which those fees and expenses are paid from plan assets (rather than by the employer) is the same.

IV. EXAMPLE OF A TDF SERIES ELIGIBLE FOR RELIEF

Employer X sponsors Plan A, which is a profit-sharing plan qualified under § 401(a) that includes a qualified cash or deferred arrangement described in § 401(k). Participants in Plan A can commence distribution upon attainment of age 65, the normal retirement age under Plan A, or upon severance from employment. Plan A provides participants the opportunity daily to direct the investment of assets held in, or contributed to, their accounts in a broad array of investment alternatives.

The designated investment alternatives available to all participants under Plan A include a series of TDFs managed by an investment manager (as defined in section 3(38) of ERISA) who acknowledges in writing that the investment manager is a fiduciary with respect to the plan. The TDFs are designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed-income exposures based on generally accepted investment theories. The same investment manager manages all the TDFs under Plan A, and makes asset allocation decisions using a consistent investment strategy under which the asset mix is designed to change over time, becoming more conservative through a gradual reduction in the allocation to equity investments and a gradual increase in the allocation to fixed-income exposure as the participants in each TDF grow older. None of the TDFs holds or permits the acquisition of employer securities.

Each TDF is available only to participants who will attain normal retirement age within a limited number of years around the target date for the fund. For example, investment in the 2020 TDF is restricted to participants who will attain normal retirement age in 2019, 2020 or 2021.

Each TDF is intended to be a qualified default investment alternative (QDIA) within the meaning of § 2550.404c-5(e) of the Department of Labor regulations, which describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be a QDIA.² The plan sponsor also represents that it will satisfy the conditions of § 2550.404c-5(c) of the QDIA regulation, including the requirement that participants be furnished a notice of the circumstances under which their assets may be invested in the QDIA, their right to direct the investment of their assets into any other plan investment alternatives, and the investment objectives, risk and return characteristics, and fees and expenses attendant to the QDIA.

² The Department of Labor has informed the Department of the Treasury that the use of unallocated deferred annuity contracts as fixed income investments would not cause the TDFs to fail to meet the requirements of § 2550.404c-5(e)(4)(i) of the QDIA regulation. It is also the Department of Labor's view that the distribution of annuity certificates as each TDF dissolves on its target date, as described in the example in this notice, is consistent with § 2550.404c-5(e)(4)(vi) of the QDIA regulation. See the Letter to J. Mark Iwry at the Department of the Treasury (October 23, 2014) from Phyllis C. Borzi, at <http://www.dol.gov/ebsa/regs/ils>.

Each TDF available to participants age 55 or older holds unallocated deferred annuity contracts as a portion of its fixed-income exposure. The deferred annuity contracts are purchased from an insurance company that is independent from the investment manager. None of the TDFs provides a GLWB or GMWB feature.

As the age of the group of participants in such a TDF increases, a larger portion of the assets in the TDF will be used to purchase deferred annuities each year. The TDFs available to participants younger than age 55 do not include deferred annuity contracts. However, the series of TDFs is designed so that, as the asset allocation changes over time, each TDF will include deferred annuity contracts beginning when the participants in that TDF attain age 55.

Each TDF is dissolved at its target date. When a TDF is dissolved, a participant who has an interest in that TDF will receive an annuity certificate representing the participant's interest in the annuity contract held in the TDF. The certificate provides for immediate or deferred commencement of annuity payments in accordance with the terms of the annuity contract and the plan. The remaining portion of a participant's interest in that TDF is reinvested in other investment options within Plan A.

The investment manager and Employer X treat each TDF in the series in the same manner with respect to rights or features other than the mix of assets. For example, with respect to each TDF, the investment manager determines the fees and administrative expenses in a consistent manner, and the percentage of those fees and expenses that are paid from plan assets (rather than by Employer X) is the same.

Pursuant to the alternative method of compliance with the nondiscrimination requirements of § 401(a)(4) under section III of this notice, the series of TDFs in this example is treated as a single other right or feature for purposes of § 1.401(a)(4)-4. Therefore, each of the TDFs will satisfy the nondiscrimination requirements of § 1.401(a)(4)-4.

DRAFTING INFORMATION

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