

Part I

Section 401. -- Qualified Pension, Profit-Sharing, and Stock Bonus Plans

(Also §§ 401(a)(11), 417; 26 CFR 1.401(a)-20.)

Application of survivor annuity requirements to deferred annuity contracts under a defined contribution plan.

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ISSUE

How do the qualified joint and survivor annuity (“QJSA”) and the qualified preretirement survivor annuity (“QPSA”) rules, described in §§ 401(a)(11) and 417 of the Internal Revenue Code, apply when a deferred annuity contract is purchased under a profit-sharing plan in the situations described below?

FACTS

Situation 1

Company A sponsors Plan X, which is a profit-sharing plan qualified under § 401(a) with a qualified cash or deferred arrangement described in § 401(k). No portion of Plan X is an employee stock ownership plan. Plan X provides for both elective deferrals and matching contributions.

Plan X participants are permitted to direct the investment of their elective deferral and matching contribution accounts among any of the investment options available under the plan, including a deferred annuity contract that is issued by an insurance company. The plan separately accounts for all amounts by investment and contribution source.

No other annuity options are available under Plan X, and the plan is not a direct or indirect transferee of assets or benefits from another plan.

Amounts invested for a Plan X participant in a deferred annuity contract are applied at the time of investment to purchase a contract that provides for payments commencing by the first day of the first month that begins after the later of the date the participant retires or attains age 65 (subject to an exception that provides for an earlier commencement date in the case of any participant who is a 5% owner, as defined in § 416, who retires after age 70½). The amount payable under the deferred annuity contract is fixed on the first day of the first period for which an amount is paid under the contract (the annuity starting date). The amount payable under the deferred annuity

contract on the annuity starting date depends on the amount accumulated under the contract on that date and the actuarial assumptions, including interest rate and mortality assumptions, used to determine the annuity purchase rate on that date, subject to a minimum-purchase-rate guarantee set forth in the contract. Amounts invested in the deferred annuity contract can be transferred to other investments at any time before the annuity starting date.

In general, a deferred annuity contract under Plan X pays benefits in one of various life annuity forms that can be elected during the 180-day period ending on the annuity starting date, but the participant can instead elect, at any time before the annuity starting date, to have a single-sum payment. The form of payment, if no other form is elected, is a straight life annuity in the case of a participant who is not married on the annuity starting date and is a 50% joint and survivor annuity (with the surviving spouse as the joint annuitant) that is actuarially equivalent to the straight life annuity in the case of a participant who is married on that date. If the participant is married on the annuity starting date, the notarized consent of the spouse must be obtained if the participant elects a life annuity form other than a joint and survivor annuity with the surviving spouse as the joint annuitant and the survivor annuity not less than 50% or more than 100% of the joint annuity amount. Thus, for example, no spousal consent is required if a participant elects an annuity that satisfies the definition for a qualified optional survivor annuity ("QOSA") described in § 417(g).

Plan X provides that if a participant dies prior to the annuity starting date under the deferred annuity contract, the participant's surviving spouse (or, if there is no surviving spouse, the participant's designated beneficiary) will receive a death benefit equal to the nonforfeitable accrued benefit under the contract as of the date of death. The nonforfeitable accrued benefit under the deferred annuity contract is the contract's value calculated by taking into account 100% of the amounts attributable to both elective deferrals and matching contributions. In the case of a married participant, the death benefit is paid to the surviving spouse in the form of an annuity for the life of the surviving spouse (unless the surviving spouse elects a single-sum payment).

With respect to amounts not invested in a deferred annuity contract, Plan X provides that, upon the death of a participant, the participant's nonforfeitable accrued benefit (reduced by any security interest held by the plan on account of an outstanding participant loan) is payable in full to the participant's surviving spouse (or, if there is no surviving spouse or the surviving spouse gives notarized consent, to a designated beneficiary).

Participant P invests portions of his Plan X elective deferral and matching contribution accounts in the deferred annuity contract on various dates from age 45 to age 65, and retires at age 65. The annuity starting date for Participant P's benefit under the deferred annuity contract is the first day of the month after he retires.

Situation 2

The facts are the same as in Situation 1, except as follows.

A Plan X participant who invests amounts in a fixed deferred annuity contract may not subsequently transfer those amounts out of the contract and may not elect to take those amounts in the form of a single-sum payment. Thus, amounts invested in the deferred annuity contract will be paid in the form of a life annuity, without an option for the participant to accelerate payment of the amounts in the form of a single-sum payment.

The amount payable under the deferred annuity contract on a Plan X participant's annuity starting date in the form of a straight life annuity that is attributable to an amount invested in the contract is fixed on the date the investment is made. Thus, the amount payable under the fixed annuity contract depends on the amount invested in the contract on the date the investment is made and the actuarial assumptions, including interest rate and mortality assumptions, used to determine the annuity purchase rate on that date.

Situation 3

The facts are the same as in Situation 2, except as follows.

A Plan X participant who invests amounts in a deferred annuity contract can make an election to have no benefits payable under the contract with respect to amounts invested in the contract that are attributable to matching contributions in the event of death before the annuity starting date. If the participant makes this election, then the participant's spouse, if any, must give notarized consent to the election.

LAW

Section 401(a)(11) sets out two requirements regarding annuity benefit forms for certain retirement plans qualified under § 401(a). Except as provided under § 417, § 401(a)(11)(A)(i) requires that, in the case of a vested participant who does not die before his or her annuity starting date, the accrued benefit payable to the participant be provided in the form of a QJSA and § 401(a)(11)(A)(ii) requires that, in the case of a vested participant who dies before his or her annuity starting date and who has a surviving spouse, a QPSA be provided to the participant's surviving spouse.

Section 401(a)(11)(B)(i) and (ii) provides that the QJSA and QPSA requirements apply to any defined benefit plan and to any defined contribution plan that is subject to the funding standards of § 412. (Section 412(e)(2)(A) provides that the funding standards of § 412 do not apply to any profit-sharing or stock bonus plan.)

Section 401(a)(11)(B)(iii) provides that the QJSA and QPSA requirements also apply to a participant under any other defined contribution plan (i.e., a profit-sharing or stock bonus plan) unless:

- The plan provides that the participant's nonforfeitable accrued benefit (reduced by any security interest held by the plan on account of an outstanding participant loan) is payable in full, on the death of the participant, to the participant's surviving spouse (or, if there is no surviving spouse or the surviving spouse consents, to a designated beneficiary) (§ 401(a)(11)(B)(iii)(I));
- The participant does not elect a payment of benefits in the form of a life annuity (§ 401(a)(11)(B)(iii)(II)); and
- With respect to the participant, the plan is not a direct or indirect transferee (in a transfer after 1984) of a plan that was subject to the QJSA and QPSA requirements with respect to the participant (§ 401(a)(11)(B)(iii)(III)).

Under § 401(a)(11)(B), if a defined contribution plan separately accounts for assets (and related income) that are transferred from a plan that is subject to the QJSA and QPSA requirements, then only those transferred assets (and related income) are subject to the QJSA and QPSA requirements on account of the transfer.

Section 417(a)(1) imposes a number of conditions in order for a plan to satisfy § 401(a)(11). These conditions include certain waiver, spousal consent, and written explanation rules relating to QJSAs and QPSAs, and also include requirements regarding the availability of a QOSA (as defined in § 417(g)). For example, § 417(a)(1)(A) generally imposes a condition that each participant must be able to elect at any time during an applicable election period (defined in § 417(a)(6)) to waive the QJSA form of benefit or the QPSA form of benefit (or both). However, under § 417(a)(5), this requirement that a participant be able to elect to waive the QJSA or QPSA form of benefit (as the case may be) does not apply if such benefit may not be waived (or another beneficiary selected) and the plan fully subsidizes the costs of such benefit.

Section 417(b) defines a QJSA as an annuity (1) for the life of the participant with a survivor annuity for the life of the spouse that is not less than 50% nor more than 100% of the amount of the annuity payable during their joint lives and (2) that is the actuarial equivalent of a single annuity for the life of the participant.

Section 417(c)(2) defines a QPSA, in the case of a defined contribution plan, as an annuity for the life of the spouse the actuarial equivalent of which is not less than 50% of the portion of the account balance of the participant (as of the date of death) to which the participant had a nonforfeitable right under § 411. For a defined contribution plan, the accrued benefit is defined in § 411(a)(7)(A)(ii) as the balance of the employee's account. In general, under § 417(f)(2)(A), the annuity starting date is the first day of the first period for which an amount is payable as an annuity or, in the case of a benefit not payable in the form of an annuity, the first day on which all events have occurred which entitle the participant to the benefit.

Section 401(a)(7) provides that, to be qualified under § 401(a), a retirement plan must satisfy the requirements of § 411. Section 411(a) requires that a plan provide that certain benefits are nonforfeitable upon attainment of normal retirement age or the completion of a specified number of years of service. However, § 411(a)(3)(A) permits certain forfeitures upon a participant's death (except in the case of a survivor annuity described in § 401(a)(11)). Pursuant to § 401(k)(2)(C), a qualified cash or deferred arrangement must provide that an employee's right to his or her accrued benefit derived from elective contributions is nonforfeitable. Section 1.401(k)-1(c)(2) of the Income Tax Regulations provides that the amount attributable to an employee's elective contributions may not be forfeited under § 411(a)(3)(A). In addition, § 1.401(a)-20, Q&A-20, provides that a contributory defined contribution plan with a § 411(a)(3)(A) forfeiture provision may not use more than a proportional percent of the account balance attributable to contributions that may not be forfeited at death (such as elective deferrals) to satisfy the QPSA benefit. Thus, for example, where a participant's date-of-death account balance comprises 60% attributable to elective deferrals and 40% attributable to matching contributions, the maximum portion of a QPSA that can consist of amounts attributable to elective deferrals is 60%.

Section 1.401(a)-11(b)(1) defines a life annuity to mean an "annuity that provides retirement payments and requires the survival of the participant or his spouse as one of the conditions for any payment or possible payment under the annuity." Thus, a joint and survivor annuity is a "life annuity" under this definition.

Section 1.401(a)-20 sets forth additional rules reflecting the amendments to § 401(a)(11) by the Retirement Equity Act of 1984, P.L. 98-397, and the enactment of § 417.

Under § 1.401(a)-20, Q&A-4, if a defined contribution plan separately accounts for an amount with respect to which a participant elects a life annuity, then only that separate account balance is subject to the QJSA and QPSA requirements on account of the participant's election of a life annuity.

Under § 1.401(a)-20, Q&A-37, if a plan fully subsidizes a QJSA or QPSA and does not allow a participant to waive the QJSA or QPSA, respectively, or to select a nonspouse beneficiary, then the plan is not required to provide the written explanation required by § 417(a)(3)(A) or (B). However, if the plan offers an election to waive the benefit or designate a beneficiary, it must satisfy the election, consent and notice requirements with respect to the subsidized benefit. Under § 1.401(a)-20, Q&A-38(b), a QPSA is fully subsidized in a defined contribution plan.

ANALYSIS

Since Plan X is neither a defined benefit plan nor a defined contribution plan that is subject to the funding standards of § 412, the plan satisfies the first two conditions in § 401(a)(11)(B) for the exception to the application of the QJSA and QPSA requirements. Under § 401(a)(11)(B)(iii), a plan must satisfy three additional conditions,

set forth in § 401(a)(11)(B)(iii)(I), (II), and (III), to avoid being subject to the QJSA and QPSA requirements.

In Situation 1, Plan X satisfies the § 401(a)(11)(B)(iii)(I) condition because a participant's entire nonforfeitable accrued benefit, including amounts attributable to the investment in the deferred annuity contract, is payable in full, on the death of the participant prior to the annuity starting date, to the participant's surviving spouse (or, if there is no surviving spouse, the participant's designated beneficiary). Plan X satisfies the § 401(a)(11)(B)(iii)(III) condition because Plan X is not a direct or indirect transferee of a plan that was subject to the QJSA and QPSA requirements with respect to any participant.

Plan X also satisfies the § 401(a)(11)(B)(iii)(II) condition that the participant not elect a payment of benefits in the form of a life annuity. Although a life annuity is the default payment under the deferred annuity contract in Situation 1, Participant P can elect another form of payment prior to the annuity starting date under the contract, either by transferring amounts invested in the contract to another investment option (with respect to which other forms of distribution are available) or by electing a single-sum payment under the contract. Thus, in the absence of an affirmative election of a life annuity during the 180-day period ending on the annuity starting date, Participant P does not elect a life annuity under the deferred annuity contract until his annuity starting date with respect to the contract. Because Participant P does not elect a life annuity under the deferred annuity contract until his annuity starting date with respect to the contract, and the other conditions are satisfied for the exception under § 401(a)(11)(B)(iii), the plan is not subject to the QPSA requirements before the annuity starting date.

However, at the annuity starting date, if Participant P has not previously elected to receive another form of payment, Plan X becomes subject to the QJSA requirements with respect to the deferred annuity. Because Plan X separately accounts for the deferred annuity contract, the remainder of the plan is not subject to the QJSA and QPSA requirements.

In Situation 2, Plan X is generally subject to the QJSA and QPSA requirements of § 401(a)(11) with respect to Participant P's benefits under the deferred annuity contract beginning when Participant P first invests in the contract. The deferred annuity contract does not qualify for the exception under § 401(a)(11)(B)(iii) because, at the time Participant P invests amounts in the contract, he has elected a life annuity within the meaning of § 1.401(a)-11(b)(1).

The death benefit under the deferred annuity contract in Situation 2 provides the participant's surviving spouse a life annuity that is based on 100% of the amounts in the contract attributable to both elective deferrals and matching contributions. This satisfies the requirements for a QPSA under § 1.401(a)-20, Q&A-20, and, in particular, the requirement in § 1.401(a)-20, Q&A-20, that the plan provide a preretirement survivor

annuity with a value which is not less than 50% of the nonforfeitable account balance as of the date of the participant's death.

Further, because the QPSA in Situation 2 satisfies the requirements in § 417(a)(5) that (1) the plan fully subsidize the costs of the QPSA (i.e., no charge is imposed for the coverage) and (2) a participant may not waive the QPSA or select a nonspouse beneficiary, Plan X is not required to provide the written QPSA explanation otherwise required by § 417(a)(3) or obtain spousal consent with respect to a QPSA. However, since the QJSA does not satisfy the requirements of § 417(a)(5), Plan X must obtain notarized spousal consent for a participant to waive a QJSA and must provide the written QJSA explanation required by § 417(a)(3) before the annuity starting date.

The result would be the same if, in order to maximize the annuity payable during the participant's lifetime, death benefits under the deferred annuity contract were reduced to the minimum permissible. In such case, the QPSA would be based on 50% of the amounts invested in the contract that are attributable to elective deferrals and 50% of the amounts invested in the contract that are attributable to matching contributions. In addition, a death benefit based on the remaining 50% of the amounts invested in the contract that are attributable to elective deferrals would be payable to the participant's designated beneficiary.

In Situation 3, for the reasons described with respect to Situation 2, Plan X is generally subject to the QJSA and QPSA requirements of § 401(a)(11) with respect to Participant P's benefits under the deferred annuity contract beginning when Participant P first invests in the contract.

However, unlike in Situation 2, Plan X in Situation 3 is required to comply with the rules of § 417(a) with respect to the participant's waiver of the QPSA. This is because the § 417(a)(5)(A) exception from the requirements of § 417(a) imposes two conditions: (1) that the benefit not be waived and (2) that the benefit be fully subsidized. In Situation 3, unlike in Situation 2, the plan allows Participant P to waive the QPSA and thus must provide a written explanation and obtain notarized spousal consent to any waiver.

HOLDINGS

In Situation 1, Plan X qualifies for the exception in § 401(a)(11)(B)(iii), and thus is not subject to the QJSA and QPSA requirements of § 401(a)(11) with respect to Participant P's deferred annuity contract until Participant P's annuity starting date under the deferred annuity contract.

In Situation 2, Plan X is generally subject to the QJSA and QPSA requirements of § 401(a)(11) with respect to the deferred annuity contract beginning when Participant P first invests in the contract. The death benefit provided under the deferred annuity contract in Situation 2 satisfies the requirements to be a QPSA under § 1.401(a)-20, Q&A-20. Because the QPSA is fully subsidized in Situation 2 (i.e., no charge is

imposed for the coverage) and Plan X does not allow Participant P to waive the QPSA or to select a nonspouse beneficiary, the plan is not required to obtain spousal consent with respect to the QPSA.

In Situation 3, Plan X is generally subject to the QJSA and QPSA requirements of § 401(a)(11) with respect to the deferred annuity contract beginning when Participant P first invests in the contract. Because Plan X permits a participant to waive the QPSA, any such waiver must be accompanied by the spouse's notarized consent following a written explanation in accordance with the rules of § 417(a)(2) and (3).

In all three situations, because Plan X separately accounts for the deferred annuity contract, the remainder of the plan is not subject to the QJSA and QPSA requirements.

DRAFTING INFORMATION

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