New Guidance Encourages Annuities
Within Target Date Funds

The Internal Revenue Service (IRS) and Department of Labor (DOL) have issued guidance that will enable defined contribution plans to include deferred annuities within target date funds (TDFs) offered only to older participants.

**Background**
TDFs are investment funds that use a mix of equity and fixed income exposures to provide varying degrees of long-term appreciation and capital preservation, based on the participant's age, target retirement date, or life expectancy. TDFs automatically change their asset allocation and associated risk level over time with the objective of becoming more conservative as the participant ages. When a plan offers a series of TDFs, each fund is usually set up to move underlying investments from equities to fixed income at a specific triggering age.

Why not consider moving TDF investors into annuities automatically as they get closer to retirement? Allowing TDFs to invest in an annuity as part of the underlying investments has been of interest to participants seeking a lifetime income stream. An annuity can either start payments to participants shortly after retirement age, or at some age in the future to protect participants from outliving their assets.

**The Problem**
The roadblock to annuities within a TDF series has been with the IRS' nondiscrimination requirements. Only the segment of TDFs for participants generally age 55 or older would contain annuities, whereas funds for those below the age of 55 would not. Because annuities are not available to younger participants, a participant below age 55 would be prohibited from investing in a specific segment of their plan's TDF series. TDFs with annuities are therefore only available to older participants, many of whom are likely highly compensated employees, creating a nondiscrimination issue. Restricting a segment of a plan's TDF series to a specific age group violates the current availability requirement for benefits, rights, and features which says that the right to each form of investment, available under a plan, must be made available in a nondiscriminatory manner.

Not only were there potential issues with the IRS' discrimination rules, but assuming you could get past that, the DOL's rules were also cause for concern. Because TDFs make up the vast majority of qualified default investment alternatives (QDIAs), would restricting some participants from accessing a QDIA cause the TDF series to fail the QDIA safe harbor rules? Perhaps the most significant hurdle was the DOL's annuity selection fiduciary safe harbor, which required a plan fiduciary to conclude, at the time of the selection, that the annuity provider is financially able to make all future payments under the annuity.
contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract.

The Fix
New guidance by the IRS provides a special rule under which a series of TDFs restricted to older participants can be permitted for nondiscrimination purposes when the following conditions are met:

- The TDF series is a single investment program under which the same investment manager manages each TDF and applies the same generally accepted investment theories across the series of TDFs. The only difference among the TDFs can be the mix of assets. The TDF available only to older participants must become available to younger participants as the asset mix changes to reflect their increasing age.
- No deferred annuity within the TDF can provide a guaranteed lifetime withdrawal benefit (GLWB) or a guaranteed minimum withdrawal benefit (GMWB) feature.
- The TDFs do not hold employer securities that are not readily tradable on an open market.
- Each TDF within the series is treated in the same manner regarding fees and administrative expenses.

In response to the IRS guidance, the DOL issued guidance, providing that if the IRS' conditions above are met, the use of annuity contracts within a TDF series restricted to a specific age group of participants would comply with the QDIA rules. On the issue of the annuity selection, the DOL said that where the plan sponsor hires an investment manager of the TDF series who acknowledges in writing that it is a fiduciary of the plan, and who meets the annuity selection safe harbor requirements on its own, the plan sponsor could meet its fiduciary obligation. It should be noted that the plan sponsor would still retain a duty to monitor the investment manager.

Next Steps
Time will tell if the guidance encourages more plan sponsors to offer deferred annuities in their plans. Plan sponsors wishing to move forward should review their current investment policy statement, investment management agreements, and investment guidelines to ensure that their TDFs satisfy the IRS requirements and that the inclusion of this type of TDF series is permitted by the plan. The most significant step will be to ensure that each TDF available to participants age 55 and older holding annuity contracts is purchased from an insurance company that is independent from the investment manager, and does not provide GLWB or GMWB features. In addition, each TDF that is dissolved at its target date should provide the participant a certificate representing the participant's interest in the annuity contract held in the TDF; and the remaining portion of the participant's interest in that TDF is reinvested in other plan investment alternatives in accordance with ERISA.

If you have any questions, please contact your Lockton Retirement Services Team.

Fiduciary Risk Management: Compliance Services
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