ABSTRACT

The SECURE 2.0 Act of 2022 (SECURE 2.0) included a significant number of changes for qualified plans, some optional and some mandatory, that eliminate barriers to offering guaranteed retirement income products in plans and IRAs. For example, SECURE 2.0 included changes related to distributions that will impact the use of guaranteed retirement income solutions (e.g., annuities) in 401(k) plans, which could help participants with risks they face for sustainable lifetime income in retirement. A January 2022 paper entitled *The Retirement Income Challenge in 401(k) Plans: Overcoming Legal Obstacles* published by the Retirement Income Institute discussed these risk factors. The paper also explained ways in which the Setting Every Community for Retirement Enhancement Act of 2020 (SECURE 1.0) helped remove legal barriers to the inclusion of guaranteed (i.e., insured) retirement income contracts in 401(k) plans. This paper updates the earlier discussion and explores ways in which the SECURE 2.0 changes enhance the addition of guaranteed retirement income contracts to plans.
SECURE 2.0 makes it possible – along with the changes from SECURE 1.0 – for participants to avail themselves of a wider array of annuity options in order to turn their retirement savings into sustainable lifelong retirement income.

INCLUSION OF GUARANTEED RETIREMENT INCOME SOLUTIONS IN 401(K) PLANS: IMPACT OF SECURE 2.0

FRED REISH AND BRUCE ASHTON

INTRODUCTION

It is often cited that approximately 10,000 workers retire every day in the U.S., and it is estimated that this number will increase to about 12,000 per day in 2024.[1] While some of those retirees may have pension plans (which is particularly true of government and union workers) and some do not have any retirement benefits, many are participants in savings-based defined contribution plans. While those defined contribution plans have been successful in helping workers accumulate retirement benefits, they are not generally designed to provide retirement income for their participants. As a result, the burden of converting their account balances into sustainable lifelong income falls on participants in 401(k) and other participant-driven retirement savings plans.[2] However, that individual responsibility can be supported by plans offering guaranteed income with the associated fiduciary protections for the quality and expense of the guaranteed products. In that case, participants will benefit from both the guarantees and the fiduciary protections for the cost and quality of the retirement income products. This raises an important question: how can plan sponsors design and operate plans that help participants convert their 401(k) savings into sustainable retirement income?

A prior paper published by the Retirement Income Institute[3] addressed different types of assistance that participants need – including education, investment assistance, and insured products – and the reluctance of plan

1. *See, e.g.*, Vandenbroucke, Guillaume, *How Many People Will Be Retiring in the Years to Come?*, Federal Reserve Bank of St. Louise (May 30,2019). See also Myers, Kristin, *Americans are retiring at an increasing pace*, yahoo/finance (Nov. 21, 2018), referencing Census Bureau statistics.
2. This paper uses "401(k)" plans for the sake of simplicity, but that term is intended to apply to all types of defined-contribution plans.
3. Reish, Fred and Ashton, Bruce, The Retirement Income Challenge in 401(k) Plans: Overcoming Legal Obstacles, Retirement Income Institute Original Research #004-2022 (January 2022). https://www.protectedincome.org/research/the-retirement-income-challenge-in-401k-plans-overcoming-legal-obstacles/

sponsors and fiduciaries[4] to offer available retirement income solutions, such as annuities, in their plans. The paper also discussed how SECURE 1.0 helped overcome some of the practical barriers and legal concerns for offering those products.

At the end of 2022, Congress passed follow-on legislation, SECURE 2.0,[5] which includes a significant number of enhancements to qualified plans, including enrolment, participation, and employer tax credits for the creation of plans. (SECURE 2.0 contained over 90 distinct provisions related to retirement plans and benefits.) Four of the changes specifically related to distributions that enhanced the ability to make guaranteed retirement income products available in defined contribution plans and IRAs.

The four changes are:

- removal of required minimum distribution (RMD) barriers to life annuities;
- changes related to qualified longevity annuity contracts (QLACs);
- elimination of a penalty on partial annuitization;
- clarification of the substantially equal period payment rule.

This paper discusses the implications of these changes. Before detailing the impact of SECURE 2.0, however, a recap of the prior paper is provided by way of background.

1. THE NEED, THE OBSTACLES AND SECURE 1.0

1.1 PARTICIPANT NEED

U.S. employers that sponsor retirement plans have largely replaced defined benefit pension plans with savings-based retirement plans, primarily 401(k) plans. Unfortunately, for purposes of retirement income, the participant benefits in savings plans are framed as wealth (i.e., an account balance) instead of being expressed as retirement income, e.g., monthly payments of income. (Note that in SECURE 1.0 Congress made an effort to require plans to express account balances as future income in retirement in accordance with a Department of Labor (DOL) regulation. However, in the authors' opinion, the DOL regulation required that the retirement income disclosures be made in a way that was not particularly helpful to participants, thereby reducing the requirement's benefits.)

Unfortunately, much of the information provided to today's participants fails to describe the account as a source of income for their retirement years. Yet, the reality is that those retirement benefits will be spent the way wages are spent on monthly expenses during the working years. There has also been an acute lack of education about risks associated with differentiating retirement income from the "wealth buckets" of plan accounts and IRAs (e.g., life expectancy, the declining ability to make critical financial decisions as individuals age, a sustainable rate of withdrawal from the account) and on-going investment issues, such as investing for the generation of income.

The lump sum perception, when combined with a lack of education about sustainable lifetime income[6] (e.g., life expectancies, inflation, withdrawal rates), makes it difficult for many participants to understand how to convert that wealth into secure retirement income. This is complicated by the uncertainty of how long a person will live, and the common practice of retirees underestimating their life expectancies.[7] The matter is further complicated by the fact that, generally, participants do not understand many of the risks they face in converting "wealth" to "paychecks," or monthly income, in retirement.[8]

4. In this paper, "plan sponsor" and "fiduciary" refer to the entities that sponsor a 401(k) or other plan and their employees who act as ERISA fiduciaries. "Employer" is used to refer to plan sponsors when acting in non-fiduciary capacities.
5. SECURE 2.0 was included as Division T of the Consolidated Appropriations Act, 2023, enacted in December 29, 2022.
6. In this paper, the terms "sustainable" and "guaranteed" are used interchangeably, since they refer to the same thing. That is, these terms mean that the income is assured to last for the lifetime of the retire and, if desired, the retiree's partner.
7. Morelli, Steven A. 2021. "Your Clients Are Likely Underestimating Their Lifespan by 5 Years." InsuranceNewsNet.com, July 19, 2021.
8. Hou, Wenliang, *How Well do Retirees Assess the Risks They Face in Retirement?*, Center for Retirement Research at Boston College (July 2022)

To summarize, these risks include the following issues:[9]

- How long a retiree (and their partner, if any) are likely to live, which affects how long their retirement savings needs to last.
- The appropriate withdrawal rate, which may cause them to deplete their savings too quickly or too slowly, the latter having an adverse effect on their lifestyle.
- How to invest their money to fund the withdrawals, but also protect against large losses. Cognitive impairment, i.e., the fact that the ability to manage their affairs tends to diminish with age.

Policymakers have become increasingly aware of these risks and the general lack of understanding of how to manage the risks. This has led to legislative, regulatory, and service provider efforts to dismantle some of the legal and practical barriers to increase the ability of plan sponsors and fiduciaries, through their 401(k) (and other defined contribution) plans, to enable participants to convert retirement savings into income that will last for the lifetimes of retirees (and their spouses).

One alternative is for 401(k) plans to offer insured retirement income products. While the need for such products has long been recognized, there have been barriers to including these products in plans.

1.2 OBSTACLES

The legal barriers to inclusion of guaranteed retirement income solutions in savings plans are discussed in detail in the prior paper. Plan sponsors are principally concerned about their fiduciary responsibility. This concerned raised a question: how can a plan sponsor prudently select and monitor an insurance company without risk of fiduciary liability if the insurer were to become insolvent?

A U.S. Department of Labor (DOL) regulation that provided a fiduciary safe harbor process for the selection and monitoring of insurance companies and insured products proved to be so vague and demanding that few, if any, fiduciaries relied on it. Even when a fiduciary was willing to go through the process, practical issues like the lack of portability[10] of the guaranteed income products got in the way. Thankfully, the SECURE 1.0 legislation subsequently addressed many of these concerns by providing a fiduciary safe harbor for selection of insurers, guidance for selecting the insured contracts, and portability to preserve benefits where an insured product will no longer be supported by a plan.

These changes helped overcome some of the legal obstacles for providing guaranteed retirement income products in defined contribution plans. In effect, the changes support fiduciaries in their efforts to provide participants with the opportunity to select annuities or other insured retirement income contracts (e.g., guaranteed minimum withdrawal benefits, or GMWBs) to provide a secure foundation of lifelong income.

1.3 SECURE 1.0

SECURE 1.0 included several provisions to support the inclusion of guaranteed income products in savings plans:

- **Retirement income illustrations.** The Act mandated that plan sponsors provide information to participants annually about the income stream that their account balances would generate in retirement and directed the DOL to issue a regulation describing the process for developing and providing the annual income illustrations. To address the concern that a participant could later claim that they relied on an illustration that proved to be inaccurate, the statute provides that, if a plan sponsor follows the requirements of the regulation, there is a fiduciary safe harbor protecting the plan

9. *See* ERISA Advisory Council, Washington, DC. Federal Register. 2020. "Pension Benefit Statements: Lifetime Income Illustrations." 85 Fed. Reg. 182 (September 18)., and Hou, Wenliang. 2020. "How Accurate Are Retirees' Assessments of Their Retirement Risk?" Working Paper 2020-14, Center for Retirement Research at Boston College, Boston, MA

10. As used in this paper, the term "portability" refers to the ability of a participant to continue to have a portion of their account invested in a retirement income product in two situations. The first is if a plan sponsor elects to eliminate the product from the plan's lineup or to change recordkeepers and the new recordkeeper does not offer the product on its platform. The second is when a participant terminates employment at a point when, absent a special provision in the law, the participant is not entitled to take a distribution of the product.

sponsor from liability. The DOL issued an interim final regulation specifying the assumptions and disclosures that should be used in providing the illustration in September 2021. The regulation has been criticized for requiring plan sponsors to assume that the participant has reached their retirement age in the current year (regardless of the participant's actual age) and therefore does not provide actionable information and in some cases may discourage a participant from participating in the plan. Notwithstanding the criticism, the hope is that the illustrations will encourage participants to view their 401(k)-retirement savings as a source of income to be drawn on during retirement, as opposed to a lump sum of wealth.

- **Portability.** One of the barriers to inclusion of a retirement income product in a retirement plan was that, if the plan sponsor decided to change the plan's recordkeeper, for example, or eliminate the guaranteed retirement income option in the plan, the premiums paid from the participant's account would be lost (or, at least, that the anticipated protection would be lost and the participant would receive little in return for the surrender of the guaranteed income product). Again, there was a concern among plan fiduciaries that they could be sued because of those losses. SECURE 1.0 addressed this concern by providing a portability solution for changes in service providers and the decision to stop offering the retirement income products. In effect, plans may permit participants to roll over their insured benefits into individual retirement annuities (IRAs) if those benefits would otherwise be lost. This distribution and rollover provision if the plan is amended to accommodate that option, even if the participant is not otherwise eligible to withdraw benefits from the plan.
- **Fiduciary safe harbor.** The safe harbor applies to the selection of the insurer for an insured retirement income contract, but not the selection of the specific contract itself. While the safe harbor does not include detailed guidance on the factors to consider in selecting a contract, it does indicate that fiduciaries must consider cost of the contract in relation to the benefits and product features of the contract and the administrative services to be provided by the insurer under the contract.[11] The definition of a retirement income contract includes both annuities and other types of insured contracts that provide a guaranteed benefit, such as a GMWB.[12]

As a result of these changes, plan sponsors can now consider the inclusion of insured income contracts in their plans without most of the concerns about fiduciary risk, such as potential liability for future insolvency of the contract issuer; but plan sponsors still need to be prudent when selecting a contract.[13] In implementing that process, fiduciaries should consider the features and costs of the contract and the experience of the insurer in issuing and administering such contracts. The steps for plan sponsors to take in assessing contracts were addressed in section 4 and appendix A of the prior paper.

2. THE REMAINING OBSTACLES RELATED TO ANNUITIES

As noted in the Introduction, SECURE 2.0 addressed four distribution issues that were problematic for including annuities in plans. This section discusses the four provisions of the Internal Revenue Code (the Code) that were the basis for those concerns. The SECURE 2.0 provisions that responded to those concerns are then discussed in section 3 of this paper.

2.1 REQUIRED MINIMUM DISTRIBUTION ISSUE

Prior to enactment of SECURE 2.0, the purchase of commercial annuities with retirement savings from a defined contribution plan or IRA was subject to limitations related to the required minimum distribution (RMD) rules under Code section 401(a)(9). The Treasury Regulation under Code section 401(a)(9)[14] specifies the

11. *See* ERISA §404(e)(1)(B)(ii).
12. *See* ERISA §404(e)(6)(B).
13. *Id* at subsection (1)(A).

requirements for payment of RMDs from annuity contracts, including the requirement that annuity payments be nonincreasing unless the contract satisfies specified limitations on increases in annual payments, acceleration of payments and payment of death benefits.[15] The complexity of these limitations, as well as the limitations themselves, made the offering of annuity contracts for retirement income from savings plan less attractive.

2.2 QUALIFYING LONGEVITY ANNUITY CONTRACTS

In 2014, the RMD regulation was revised to add provisions related to qualifying longevity annuity contracts (QLACs).[16] The amended regulation permitted the use of plan assets to purchase an annuity in which payment was deferred until a date later than a participant's retirement or RMD starting date provided the date was not later than the month following the participant's 85th birthday. The objective of a QLAC is to ensure that a retiree will still have retirement income even if the plan account or IRA is exhausted earlier than anticipated.

The regulation limited the amount of premiums that could be charged for a QLAC (the lesser of $125,000 or 25% of the account balance) and did not provide for escalation of these limits due to inflation. In addition, the regulation created barriers to the payment of survivor benefits in the event of divorce. As with the limitations imposed on the use of annuities for the payment of required minimum distributions, these restrictions had a negative impact on the appeal of plans to provide for QLACs.

2.3 PENALTY ON PARTIAL ANNUITIZATION

The RMD regulation provides that if a participant holds both investments in a tax-preferred retirement account (e.g., an IRA) and an annuity, the assets in the account and the annuity must be bifurcated for purposes of applying the required minimum distribution rules. In other words, if a retiree has money in a 401(k) or IRA account and has an annuity, the individual must receive a distribution from both sources. This means that the individual will receive the scheduled annuity payment and also a required distribution calculated on the other assets in the plan or IRA account. This treatment results in higher minimum distributions than would have been required if the account did not hold an annuity.

As with other limitations related to RMDs, this restriction has had a chilling effect on the ability to make use of annuities for providing retirement income.

2.5 SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

Prior to enactment of SECURE 2.0, distributions from annuity contracts or from an individual's retirement plan before the individual reached age 59-1/2 (commonly referred to as an early distribution) were subject to a 10% excise tax under Code sections 72(q) and (t), respectively. In both cases, however, the Code provided a number of exceptions to the tax on early distributions. The relevant exception for this discussion is the substantially equal periodic payment exception.[17]

In the case of annuities under section 72(q), however, the equal periodic payments exception did not apply if the series of payments is modified before the individual reaches age 59-1/2 or before the close of the five-year period beginning with the first payment under the contract and ending after the individual reaches age 59-1/2. In other words, the 10% excise tax would still apply. In the case of periodic payments under section 72(t), the law has been unclear whether payments under annuity contracts in certain situations, e.g., in the case of an exchange of the contract for another, meet the substantially equal requirement.

The changes and corrections made in SECURE 2.0 are discussed in Section 3.

14. *See* Treas. Reg. §1.401(a)(9)-5, Q&A-1(e), which references the rules and limitations under §1.401(a)(9)-6.
15. *Id* at Q&A-14.
16. Treas. Reg. §1.401(a)(9)-6, Q&A-17.
17. Code §§72(q)(2)(D) and (t)(2)(A)(iv). Both sections refer to distributions which are "part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary..."

3. THE SECURE 2.0 SOLUTIONS

3.1 REMOVAL OF RMD BARRIERS TO LIFE ANNUITIES[18]

What Changed

SECURE 2.0 amends the RMD provisions in Section 401(a)(9) of the Internal Revenue Code to provide that commercial annuities purchased under defined contribution plans and IRAs will not be deemed to violate the RMD rules because they provide (i) annual payment increases up to 5% per year, (ii) reasonable lump sums that commute future payments, (iii) acceleration of up to 12 months of payments, (iv) reasonable dividends and similar distributions, or (v) death benefits equal to cost minus prior payments.

What It Means

The RMD rules are intended to limit lengthy tax deferrals by preventing annuity contracts from providing distributions that begin small and grow at a high rate over time. Unfortunately, the rule often meant that even modest increases in distributions were problematic. Without features like those in the new provision, flexible products that could respond to the needs of retirees were limited and individuals may have been less likely to choose them as part of their 401(k) and other defined contribution plans or IRAs. The SECURE 2.0 changes reflect Congressional intent to encourage the use of life annuities to reduce/ avoid the risk of running out of retirement money.

When It's Effective

The change to the RMD rules went into effect on January 1, 2023.

3.2 QLAC CHANGES[19]

What Changed

SECURE 2.0 requires the Treasury Department (within 18 months) to amend the QLAC provisions in the RMD regulations to (i) repeal the 25% premium limit, (ii) increase the dollar premium limit from $125,000 to $200,000 (to be indexed), (iii) provide that compliant QLAC benefits purchased with joint and survivor (spousal) benefits will not become non-compliant due to a subsequent divorce, and (iv) permit QLAC recission within 90 days of purchase.

What It Means

The RMD rules (which require payments to commence at an age earlier than QLAC payments begin) have been an impediment to the use of QLACs in plans and IRAs. While the Treasury Department previously amended the RMD regulations to exempt QLACs until the actual commencement of payments, the SECURE 2.0 changes make further improvements (which Treasury was not previously authorized to make) to encourage additional use of QLACs. The changes reflect Congressional intent to encourage QLACs as a means for retirees to hedge their longevity risk.

When It's Effective

The provisions relating to premium limits are immediately applied. The provisions relating to joint and survivor spousal benefits and the 90-day "free look" period apply retroactively to contracts purchased or received via exchange after July 2, 2014.

3.3 ELIMINATION OF PARTIAL ANNUITIZATION PENALTY[20]

What Changed

SECURE 2.0 requires the Treasury Department to amend the RMD regulations so that individuals with 401(k) and other defined contribution plan accounts (and IRAs) that include annuities can have their RMDs determined based on the total value of the account, including the annuity (and reduced by any payments during the year from the annuity).

What It Means

Previously, where a tax-deferred retirement account also held an annuity, the portion of the account holding the annuity and the rest of the account had to be treated separately for calculating RMDs. The practical result was that higher RMDs could have been required, as compared to an account of equal value with no annuity.

18. SECURE 2.0, Section 201
19. SECURE 2.0, Section 202
20. SECURE 2.0, Section 204

When It's Effective

The change is effective immediately and is subject to a "reasonable good faith interpretation" standard until the Treasury Department issues regulations.

3.4 CLARIFICATION OF SUBSTANTIALLY EQUAL PERIODIC PAYMENT RULE[21]

What Changed

SECURE 2.0 clarifies that, for purposes of the "substantially equal periodic payment" exception to the 10% penalty tax on early retirement account distributions, transfers and rollovers between tax-advantaged plans, 1035 exchanges, and payments from annuities that satisfy the RMD rules will not be treated as "modifications" to the payment stream.

What It Means

Where a periodic payment stream (i.e., paid over an individual's life, or joint life with a spouse) is subsequently modified, relief from the 10% penalty tax may be lost. SECURE 2.0 provides that transfers and rollovers (where payments from both plans would satisfy the "substantially equal periodic payment" requirement together), exchanges, and annuity payments complying with the RMD rules, will not cause the relief to be lost.

When It's Effective

The change applies (i) to transfers, rollovers, and exchanges after December 31, 2023, and (ii) immediately to annuity distributions complying with the RMD rules.

CONCLUSION

Before the enactment of SECURE 2.0, the Code and Regulations included several barriers to the offering of guaranteed retirement income products in plans and IRAs. As part of the Congressional effort to help participants deal with risks they face in retirement, four changes were made to the distribution provisions of Code intended to facilitate – and possibly foster – the use of these products in plans. By modifying the required minimum distribution rules with respect to life annuities, changing rules related to QLACs, eliminating penalties on partial annuitization, and clarifying the substantial equal periodic distribution rule, SECURE 2.0 makes it possible – along with the changes from SECURE 1.0 – for participants to avail themselves of a wider array of annuity options in order to turn their retirement savings into sustainable lifelong retirement income.

21. SECURE 2.0, Section 323.

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Fred currently serves on the CFP Board's Public Policy Council and is a member of the CFP Board's Standards Resource Commission. He has written more than 350 articles and four books about retirement plans.

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