

ERISA Protections for Annuitants in Pension De-risking Transactions Today,

more plan sponsors are choosing to transfer pension plan risk through de-risking transactions. These transactions typically involve either transferring risk to the plan participant through lump sum distributions or transferring risk to an insurance company in the form of a distributed annuity. This paper describes the important protections under the Employee Retirement Income Security Act of 1974 (ERISA) that apply when an employer purchases annuities to secure benefits in connection with a pension de-risking transaction. In short, annuitants in these transactions not only benefit from the continued receipt of lifetime income, but also from continued spousal and creditor protections carried over from their ERISA-covered plan.

ERISA ENSURES PLANS AND PARTICIPANTS ARE PROTECTED

Plan officials responsible for implementing de-risking transactions are governed by ERISA's fiduciary standards, described by courts as the "highest known to the law." These standards not only require that plan fiduciaries act prudently in carrying out their responsibilities, but that they act solely in the interest of the plan's participants and beneficiaries. In satisfying these standards, plan fiduciaries must, in compliance with Department of Labor's (DOL) guidance in Interpretive Bulletin 95-1, take steps calculated to obtain the safest available annuity, as well as to ensure that the annuity contract fulfills all other applicable requirements of ERISA and the Internal Revenue Code (the Code).

Congress intentionally framed ERISA to permit fiduciaries to satisfy their duties by distributing benefits through the purchase of a private annuity. Annuity contracts represent the only exception to the ERISA trust requirements for plans because they are accepted as an ERISA trust equivalent. Moreover, the DOL has recognized since 1975 that once a plan has fulfilled its obligations and secured benefits through an annuity, the ERISA fiduciary and other requirements are generally no longer relevant, as ERISA was designed to protect participants from employer actions and ensure that they receive their promised benefits. However, the benefits of ERISA coverage are not "lost" in a de-risking transaction.

Significantly, when a pension obligation is assumed by an insurer, that obligation is a guarantee that the participant will be provided the same annuity benefit determined by the plan's fiduciaries to be due the participant under the terms of the plan. These annuities are considered distributed annuities under Code section 401(g). The Code and Treasury regulations require that the annuity be nontransferable. The annuity cannot be surrendered to the insurance company or sold. There are concerns, however, about third-party companies attempting to "buy" annuity payments by offering lump-sum amounts or "advances" in exchange for receiving all or part of their annuity income stream. The marketing of such "advances," however, is not limited to holders of annuity contracts, but extends to recipients of payments from defined benefit plans as well. See the recent GAO report on pension factoring.

SPOUSAL PROTECTIONS

The same spousal protection rules apply, whether the benefit is provided as a stream of payments directly from the plan or through an annuity. (See Treas. Reg. section 1.401(a)-20, Q&A 2, which provides that qualified joint and survivor annuity (QJSA) requirements extend to payments under the annuity contract, not simply the distribution of the annuity contract.) If the participant is a retiree in pay status already receiving an annuity, then the annuity provided by the private insurer must be the same type of distribution that the participant has already elected and is already receiving (e.g., single life annuity, joint and survivor annuity, life and period certain, etc.). If the employer does not purchase an annuity that satisfies the participant's election, then the plan sponsor's liability is not extinguished.

If a de-risking transaction takes place before the participant has made a benefit election, then the spousal consent rules would apply – the participant would need to obtain spousal consent to elect any distribution form other than a QJSA (or a qualified optional survivor annuity (QOSA)), just as is the case under the plan.

CREDITOR PROTECTIONS

ERISA provides strong creditor protections, and those protections do not go away merely because an annuity is purchased on behalf of an ERISA plan participant, by an ERISA plan. If a plan participant enters bankruptcy, his ERISA benefit receives special protection and is not included in the bankruptcy estate under Federal law. In 2005, changes were made to the Federal Bankruptcy Code. Section 522(b)(3)(C), or alternatively section 522(d)(12), broadly exempts retirement funds that are exempt under Code section 401. Distributed annuities from qualified plans are exempt under Code section 401(g), so they would be covered by this exemption. The Bankruptcy Code also exempts direct transfers from one retirement account to another.

Even outside of the context of bankruptcy, ERISA's broad anti-alienation provision prohibits the assignment or alienation of ERISA retirement benefits. Group annuity certificates issued to participants to provide qualified plan benefits are required to follow the plan provisions and form of benefit rules, and therefore do not permit assignment to creditors or any other party. See IRS General Counsel Memorandum 39882 (May 27, 1992) and Treas. Reg. §1.401(a)-20, Q&A-2.

ERISA DISCLOSURES

The ERISA disclosures required for defined benefit plans are designed to ensure that participants understand their rights, obligations and entitlements under the plan in which they participate. At the time individuals cease to be participants covered under a plan – as would be the case following the distribution of all of a participant's benefits from the plan, whether by lump sum distribution or annuity - information pertaining to the plan is no longer needed by or relevant to the participant. For example, summaries of subsequent changes to the plan or changes in the plan's funding status would have no bearing on an annuitized participant's rights, obligations, or entitlements under the plan and, therefore, provide no discernible benefit to such a participant. Similarly, furnishing an annual benefit statement to an annuitized participant with respect to which a payable accrued and vested benefit determination has already been made and disclosed serves no meaningful purpose. As noted above, before a distribution can be made, the participant must receive notice of the QJSA provisions that includes an explanation of the requirement to obtain spousal consent before a non-QJSA distribution form, including a lump sum, may be elected. This must be provided before the annuity form of benefit is provided.

Complementing the many ERISA protections afforded participants in connection with de-risking transactions, insurers have dedicated significant resources to ensure that participants and retirees understand, through clear and concise disclosures, the transaction and how they are affected, the consequences of any decisions they may have to make, and their rights under the annuity contract. For insurers, the longer-term satisfaction of annuitants is an imperative, and participant communications are an integral element of new case implementation.

PBGC COVERAGE

When a participant's or class of participants' pension obligation is annuitized, the plan is no longer required to pay premiums to the Pension Benefit Guaranty Corporation (PBGC) on behalf of those participants because the liability for payment of annuitized benefits has been legally transferred from the plan to an insurer. In the case of annuitized benefits, the guarantee of payment is now the obligation of a licensed insurance company that is subject to stringent solvency standards and oversight by state insurance regulators. In addition, all states manage state guaranty funds that are intended to protect promised benefits against the failure of any one insurer. Unlike the PBGC protections, which are subject to caps on promised benefits, annuitized benefits are not subject to a defined guarantee.



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