PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

April 2004

Retirement Plans Must Revise QJSA Explanations To Comply With New IRS Rules

The Internal Revenue Service ("IRS") has issued final regulations further clarifying what information retirement plan sponsors must provide to participants when notifying them about Qualified Joint and Survivor Annuities (QJSA) and Qualified Pre-retirement Survivor Annuities (QPSA) that are payable under the plan. The new disclosure requirements are intended to allow participants to compare more readily the value of the QJSA and QPSA forms of benefit to the value of other optional forms of benefit available under a plan.

As some plans may need to revise significantly the content of their current QJSA and QPSA explanations to comply with these regulations, it is essential that plan sponsors begin to review these new requirements immediately.

The final regulations are applicable to QJSA explanations for distributions with benefit starting dates on or after October 1, 2004 and to QPSA explanations provided on or after July 1, 2004. However, since QJSA explanations must be provided to participants 30-90 days prior to the benefit starting date, QJSA explanations should be revised as early as July 1, 2004 (in order to be available to those participants commencing benefits on October 1).

A failure to revise a plan's notices may expose the plan to potential claims by participants who may argue they were not properly informed about their benefit options. Furthermore, the IRS may impose penalties if faulty notices are discovered on audit.

A copy of this Client Alert may also be accessed on line at www.proskauer.com.

Background

The Internal Revenue Code (the "Code") requires defined benefit pension plans and some defined contribution plans (*e.g.*, money purchase pension plans) to pay retirement benefits in the form of a QJSA and pre-retirement death benefits in the form of a QPSA, unless these benefit forms are properly waived by the participant with spousal consent, if applicable. A QJSA for a married participant is an annuity paid for the life of the participant, with a survivor annuity paid for the life of the participant's spouse that is at least 50% of the amount payable during the participant's lifetime. (For an unmarried participant, the QJSA requirement is satisfied by paying the benefit in the form of a single life annuity.) A QPSA is an annuity payable to the surviving spouse of a participant who dies prior to retirement.

Plans are currently required to provide each participant with a written notice explaining the QJSA and any other optional forms of benefit available under the plan. The new regulations consolidate the QJSA and QPSA notice content requirements and provide instructions on how information must be disclosed to participants.

QJSA Notice Requirements

The new regulations require that QJSA explanations include a description of:

- each optional form of benefit generally available to participants under the plan, its eligibility conditions, and other material features;
- the **financial effect** of electing each optional form of benefit; and
- in the case of a defined benefit plan, the **relative value** of each optional form of benefit as compared to the value of the QJSA.

The new regulations' provisions regarding the required content of the financial effect and relative value disclosures are quite complicated. Discussed below are the pertinent provisions regarding each disclosure.

Financial Effect of Electing Optional Form of Benefit. When explaining the financial effect of electing an optional form of benefit other than the QJSA, plan sponsors must describe the amount payable to the participant during the participant's lifetime under the optional form, and the amount payable as a death benefit. A plan can use reasonable estimates, such as a reasonable assumption for the age of the participant's spouse, to calculate the financial effect. However, the QJSA notice must state that the plan will provide a more precise calculation upon a participant's request.

For defined contribution plans, the financial effect description must include a statement that the annuity will be provided by purchasing an annuity contract from an insurance company with the participant's account balance under the plan.

Relative Value of Optional Forms of Benefit (Defined Benefit Plans Only). Because it can be difficult for a participant to compare the relative values of optional benefit forms (*e.g.* lump sum vs. annuity), the new regulations require plan sponsors to provide participants with information regarding these benefits in a manner that will enable a participant to compare optional benefit forms meaningfully. To that end, the new regulations require plan sponsors to convert each optional benefit form, taking into account the time value of money and life expectancies, so that all optional benefit forms and the QJSA are expressed in the same form. In converting each optional benefit form, plan sponsors must use "reasonable" actuarial assumptions. With the exception of determining lump sum payments, these assumptions need not be the same as the actuarial assumptions used under the plan for determining benefit payments.

Once optional forms have been converted, the relative value of each must be presented in a uniform format that facilitates comparison. The following methods are acceptable methods of presentation:

- expressing the value of each optional benefit as a percentage of the value of the QJSA;
- stating each optional form as an annuity that is payable at the same time and under the same conditions as the QJSA; or
- stating the present value of the optional forms and the QJSA.

However, if an optional benefit form is approximately equal in value to the QJSA (as defined in further detail in the regulations), the QJSA notice need only disclose that the optional benefit is "approximately equal in value to the QJSA." Moreover, if two or more optional benefit forms have approximately the same value (as defined in further detail in the regulations), those optional benefit forms may be grouped together (by disclosing an approximate, representative relative value of one of those forms) and comparing that group of options to the value of the QJSA.

In addition to the comparison of optional forms of benefits described above, the relative value description must also explain:

- that the relative value comparison is intended to allow the participant to compare the total value of distributions paid in different forms, and that the comparison is made by converting the value of optional forms to a common form;
- that relative value calculations were determined based on an estimate of average life expectancies and that the relative value of the benefit actually received will depend on actual longevity; and
- the actuarial assumptions used in calculating relative values (or offer to disclose the actuarial assumptions upon the participant's request).

Providing Information to Participants. Plan sponsors may choose to provide the required financial effect and relative value information through either a **participant-specific** or a **generalized** notice.

A **participant-specific** notice explains financial effect and relative value information on an individualized basis, taking into account such factors as the participant's age and years of service. The plan may nevertheless use certain reasonable estimates (such as a reasonable assumption about the age of the participant's spouse) to calculate this information. If a plan uses reasonable estimates, the notice must state that a participant may request a more precise calculation.

A **generalized notice** may use a chart (or other comparable device) to illustrate the financial effect and relative value of optional forms of benefit, but still must disclose the actual amount of the benefit payable to the participant under the normal form of benefit. The notice must also describe the effect of significant variations in age and other variables from the assumed factors used to create the chart, and include a statement indicating the participant's right to receive more personalized information.

Each plan sponsor should decide whether the plan will use the general or participant-specific format for the notice. For example, for some plans, a generalized notice may provide sufficient information for most participants on the relative value of the various optional forms of benefits. However, a participant-specific notice may be preferable where the plan provides several optional forms of benefit and the plan cannot use the simplified presentation rules described above.

Moreover, if a plan typically receives many questions from participants on benefit forms, the plan sponsor may find that providing the participant-specific information initially may be more efficient.

QPSA Notice Requirements

The new regulations also include requirements regarding the content of a QPSA notice (*i.e.,* the notice describing the procedure for waiving the QPSA). Of course, consistent with prior IRS regulations, a plan must permit the waiver of the QPSA and provide a QPSA notice *only* if it requires a participant to pay for QPSA coverage or allows a participant to name a death benefit beneficiary other than his or her spouse.

The new regulations' provisions regarding the content of a QPSA notice are quite similar to the previously discussed QJSA provisions. However, unlike the QJSA notice, a QPSA notice need not disclose relative value information.

In general, the new regulations require that QPSA explanations include:

- a general description of the QPSA,
- the circumstances under which it will be paid, if elected,
- the availability of the QPSA election, and
- a description of the **financial effect** of the election of the QPSA on the participant's benefit (*i.e.*, an estimate of the reduction to the participant's retirement benefit if the QPSA is elected).

Like the QJSA notice, a plan may describe the financial effect of the QPSA election through either participant-specific information or a more generalized notice. However, if QPSA coverage does not result in a reduction to a participant's normal retirement benefit, a plan need not disclose this information.

Implications for Plans

If all the optional forms of benefit provided under a plan are actuarially equivalent to the plan's QJSA, compliance with these regulations will be fairly straightforward. Under these circumstances, the QJSA notice need not include present value or relative value information. However, the notice must nevertheless indicate that the optional forms of benefit are equal in value to the QJSA, explain the concept of relative value, and appropriately disclose the applicable interest and mortality assumptions. Because benefits such as subsidized QJSAs and QJSAs with offsets for social security, for example, result in optional benefit forms that are not actuarially equivalent to the QJSA, a plan offering any of these types of benefits must revise its QJSA notice to include relative value information.

You can also visit our Website at **www.proskauer.com**

To ensure timely compliance with the regulations, we recommend that plan sponsors:

- Identify all optional forms of benefit available under the plan and consult with plan actuaries to ascertain whether the optional forms are actuarially equivalent to the plan's QJSA;
- Evaluate benefit program software to determine whether it is capable of making the necessary financial effect and relative value calculations;
- Decide whether to provide a participant-specific or generalized notice; and
- Contact legal counsel to assist in revising QJSA and QPSA notices in accordance with the new regulations.

For further information or questions regarding these new regulations and how they affect your plan, please contact your Proskauer Rose relationship attorney.

NEW YORK LOS ANGELES WASHINGTON
BOSTON BOCA RATON NEWARK PARIS

Client Alert

Proskauer Rose LLP's nationally recognized Employee Benefits and Executive Compensation Law Group includes over three dozen attorneys and other professionals whose range of skills covers the entire spectrum of employee benefits and executive compensation law. For further information, please contact the attorneys listed below, who would welcome any question you might have:

Steven D. Weinstein
212.969.3362 — sweinstein@proskauer.com

Jeffrey Ross
212.969.3317 — jross@proskauer.com

Proskauer Rose is an international law firm that handles a full spectrum of legal issues worldwide.