

Annuities Now Allowed in Target Date Funds



Deferred annuities are now to be held by target date funds within qualified defined-contribution plans, such as 401(k) plans. The inclusion of annuities allows target date funds to provide lifetime income to employers holding such funds.

Target date funds alter their allocations by their date. Far-dated funds use an aggressive allocation strategy and the allocations gradually grow more conservative as a target date fund approaches its target date. The changes are designed to match the investment needs of various age groups.

Currently, widely available target date funds do not have an age restriction. This presents a difficulty for insurers, because it makes pricing an annuity contract difficult. Insurers prefer a restricted age group for making actuarial assumptions. By restricting specific target date funds to older employees, however, a retirement plan would run afoul of the discrimination clause in the tax code. The tax code bans qualified plans from discriminating “in favor of highly compensated employees.” To the extent that older employees have higher salaries than younger employees, restricting access to investors within a specific age group by a target date fund could cause problems.

The tax code does allow the Internal Revenue Service some flexibility in establishing guidelines for qualified plans, and the agency used this flexibility to create a special rule. Target date funds in qualified plans can now restrict the age of their shareholders if certain conditions are met. The series of target date funds offered within a qualified plan must all have the same manager and use the same generally accepted investment theories. The target date funds available to older employees can include deferred annuities, as long as those contracts don’t provide a guaranteed lifetime withdrawal benefit (GLWB) or a guaranteed minimum withdrawal benefit (GMWB). Fees and expenses must be determined in a consistent manner and the target date funds can only hold the employer’s securities if such securities are publicly traded.

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