

KELLY, HANNAFORD & BATTLES P.A.

ATTORNEYS AT LAW

3900 CAMPBELL MITHUN TOWER

222 SOUTH NINTH STREET

MINNEAPOLIS, MINNESOTA 55402

TELEPHONE (612) 341-0881

FACSIMILE (612) 341-1041

ANTHONY R. BATTLES
JULE M. HANNAFORD IV
A. DAVID KELLY
JOHN W. HAINE
SONJA LEMMER MARTENS

MARK D. MEYER
OF COUNSEL

WRITER'S DIRECT DIAL:
612/341-3398
JHaine@KHBlaw.com

April 6, 2004

Re: Optional Benefit Form Disclosures for Plans Subject to QJSA/QPSA

Dear Clients and Other Friends:

Defined benefit plans, money purchase pension plans, and other defined contribution plans that are subject to the qualified joint and survivor annuity ("QJSA") and the qualified preretirement survivor annuity ("QPSA") rules will soon have to satisfy new disclosure requirements when they inform participants of their benefit options and their right to waive preretirement survivor benefits.

The new disclosure requirements are the result of recently issued regulations that consolidate IRS guidance on the QJSA and QPSA notice rules and seek to provide participants with simpler and more meaningful benefit option comparisons. While for some plans the changes may be minor, many plans will need to provide significantly more information, especially regarding the relative value of optional benefit forms. Plans most significantly affected are likely to be defined benefit plans that:

- include a lump sum form of distribution;
- subsidize optional forms of benefit;
- calculate the amount of optional form payments using simplified factors that are not true actuarial equivalents; or
- on account of plan mergers are obligated to offer a portion of a participant's benefit in an optional form that is not generally available.

The new disclosures apply to QJSA explanations given in connection with benefits that have an annuity starting date (or, in the case of benefits with a retroactive start date, an actual payment commencement date) on or after October 1, 2004. Because those explanations ordinarily must be given no more than 90 days prior to the annuity starting date, plans should begin implementing the new rules on July 1, 2004, which is also the date on which the new rules begin to apply to explanations of the QPSA.

QJSA Compliance Alternatives. The regulations offer two ways to comply with the QJSA explanation requirements:

- Participant-Specific Notice – plans can provide participant-specific information regarding each optional form then available to the participant; or
- Generalized Notice – plans can provide a notice that explains only those optional forms that are "generally available" and that uses representative examples, rather than calculations based on the actual age and benefit of the participant, to show how the

amount payable changes and how the values of the optional form payments differ from the value of the QJSA.

If a generalized notice is provided, the notice must also include the amount payable to the participant in the plan's normal form (which may be adjusted for early commencement), and must offer to provide individualized calculations and comparisons for any optional forms presently available to the participant.

Required Information. Whether participant-specific or generalized, all optional form explanations must provide the following information:

- a description of the optional form, its eligibility conditions and material features;
- the amount(s) payable under the form (its "financial effect"); and
- the relative value of the form compared to the QJSA.

The relative value requirement, which applies only to defined benefit plans, is likely to require the most significant departure from the current practices of affected employers.

Relative Value Disclosures. The new regulations require that relative value be expressed in a way that allows participants to compare value without having to make interest or mortality assumptions. For example, plans can compare actuarial present values, they can indicate the actuarial present value of each optional form as a percentage of the actuarial present value of the QJSA, or they can convert each optional form to an annuity payable at the same time and under the same conditions as the QJSA and compare the annuity amounts. When the optional form of benefit is a lump sum, specified interest and mortality rates must be used for the comparison; for any other optional form of benefit, any reasonable and uniformly applied actuarial equivalent will do. The actuarial equivalent factors stated in the plan do not have to be used.

Simplification. The regulations offer a variety of rules that can simplify the relative value disclosure. First, a plan can avoid having to customize the disclosure based on whether the participant is married by choosing to make all relative value comparisons to the single life annuity version of the QJSA (if the same single life annuity is available to married participants) or the joint and survivor annuity version of the QJSA (if the same joint and survivor annuity is available to unmarried participants). Second, a plan can treat as having approximately the same value all optional forms of benefit with values that, as a percentage of the actuarial present value of the QJSA, fall within a 5% range. Third, if comparisons are being made to the value of a QJSA for a married person, all optional forms with values that are 95% or more of the actuarial present value of the QJSA may be treated as approximately equal in value to the QJSA, and if comparisons are being made to the value of the single life annuity QJSA, all optional forms with values that are at least 95% but not more than 102.5% of the actuarial present value of the single life annuity QJSA can be treated as approximately equal in value. Finally, even plans taking the participant-specific approach can calculate benefit amounts and relative values using reasonable estimates (e.g., calculations that assume the age of the spouse or use data as of a date earlier than the annuity starting date), but if estimates are used, the participant must be made aware of the estimate and given an opportunity to request a more precise calculation.

Explanation and Disclosure. When participant-specific information is given, the notice must:

- provide an explanation of the concept of relative value as described in the regulation, including a warning that the comparisons use average life expectancies and that actual relative value will depend on actual longevity;
- state the interest rate used to develop the comparison of optional forms (optional forms other than lump sums avoid this requirement if they are all deemed equal in value using the 5% rule noted above);
- include an offer to provide on request the actuarial assumptions used to calculate the relative values of the plan's optional forms.

In addition to the explanation of relative value and disclosure of certain interest assumptions, notices taking the generalized approach must give a general statement describing the effect of significant variations in age and other variables on the benefit amounts and their relative values.

Defined Contribution Plans. While money purchase plans and other defined contribution plans that are subject to the QJSA and QPSA rules are not subject to the relative value disclosures described above (presumably because all benefits derived from the same account balance have equivalent economic value), those plans still must satisfy the other requirements of the new rules. Consequently, if a defined contribution plan is not already providing disclosures regarding the amount of the annuity that can be purchased with a participant's account balance, they will now clearly have to do so. If the annuity amounts are estimated, i.e., if there is no assurance that an insurer will be able to provide the disclosed amount, participants will need to be apprised of that fact.

QPSA. The regulations also address the information that must be given in connection with the election to waive the QPSA. Briefly, that information includes a general description of the QPSA and an estimate of the reduction made to the participant's normal retirement benefit if the QPSA is elected. As with the QJSA, a generalized description of the financial effect of electing the QPSA can be given (such as a chart showing the effect at different ages of the QPSA election), but participants must be told they have a right to request a more individualized estimate.

Next Steps. As the foregoing discussion suggests, there are some choices to be made in dealing with the new regulations. Those choices will be influenced by, among other things, the complexity of your plan, whether your optional forms of benefit can be considered equivalent using the approximate equivalence rules in the regulation, and the extent to which your participants are likely to request individualized determinations (and defeat the benefits of generalized disclosure).

Please let us know if you would like our help in complying with these new requirements.

Sincerely,

John W. Haine