Hedging Against Longevity In Retirement Plans

Final regulations square deferred life annuities with required minimum distributions

If, as the old quip goes, the worst disease is growing old without money, then the second worst must be running out of money shortly before running out of time.

The cure might just be found in final Internal Revenue Service qualified longevity annuity contract (QLAC) regulations.[1]

QLACs pay annuities beginning when the annuitant reaches an advanced age (but not later than age 85). The payments, once begun, continue until death. QLACs may be purchased within many types of retirement plans, including:

- Defined contribution plans (for example, profit sharing and 401(k) accounts),
- Defined benefit plans,
- Internal Revenue Code Section 403(b) annuities purchased by IRC Section 501(c)(3) organizations or public schools,
- Traditional individual retirement accounts (but not Roth IRAs), and
- Eligible governmental plans under IRC Section 457(b).

Required minimum distributions (RMDs) that must begin after reaching age 70½ are determined annually based on the value of such a retirement account. Under the final regulations, that value now excludes the value of QLACs. As a result, in won't be necessary to use non-QLAC funds to make mandatory distributions based on the value of a QLAC.

The *quid pro quo* for that relief? Treasury chose to regulate certain terms of the newly-created QLAC. During the regulatory process, Treasury called for, received and considered comments about possible QLAC features. Although several regulations have been amended to accommodate the contracts, Question and Answer-17 of Treasury Regulations Section 1.401(a)(9)-6 contains the QLAC definition. But each type of account listed earlier has additional rules peculiar to that type of account.

QLACs may be purchased beginning July 2, 2014. Nonconforming annuities that predate July 2 may be exchanged for QLACs. However, the fair market value of the contract that's exchanged for a QLAC is treated as a premium that counts toward the QLAC annual premium limit.

Premium Limits

There's a limit to QLAC premiums that may be paid from a retirement account. Annual premiums must not exceed $125,000 or, if less, 25 percent of the account's value (including the QLAC's value). The $125,000 limit will be increased based on the consumer price index in increments of $10,000. For example, if the CPI is 2 percent each year for four years, the $125,000 annual premium limit will increase by $10,000 to $135,000. IRAs are aggregated for these tests. If, in any year, the limit is exceeded, the QLAC is disqualified, thus increasing that year's RMD. But there's a cure. By the end of the year following the year when the limit was exceeded, the excess premium can be returned. Alternatively, a portion of the QLAC can be converted to a non-QLAC annuity.

The annual QLAC premium that will be supported by an account is equal to the account's expected total rate of return times the account's value on the first day of the year (but not more than $125,000). For example, an account holding $1,785,714.29 at the beginning of the year that's expected to earn total annual investment returns of at least 7 percent (including QLAC value) will support a $125,000 annual QLAC premium payable at the end of each year. In any year the account balance falls below $1,785,714.29, the 25 percent premium limitation will lower the amount of the allowable QLAC premium. In practice, the account's value should be higher (or the premium should be lower) because investment volatility will likely result in returns below 7 percent in some years.

Fixed Payments

QLACs must provide an annuity payment to the plan participant. Payments must begin no later than the first day of the month following the month when the participant turns age 85. The maximum age may be adjusted in the future to reflect changes in mortality.

QLACs must not provide any commutation benefit, cash surrender right or other similar feature. Variable contracts under IRC Section 817, indexed contracts or similar contracts, can't be QLACs, except to the extent provided in future revenue rulings, notices or other IRS-published guidance. But QLACs may provide dividends, and may adjust annuity payments for cost of living increases.

Death Benefits

QLACs may provide certain death benefits, but may not provide any commutation benefit, cash surrender right or other similar feature.

Death benefits may be payable to one or more beneficiaries designated under the QLAC. In practice, this means beneficiary forms must be filled out and signed as part of the plan participant's estate planning.

Death benefits must either take the form of a survivor annuity or a return of premium. Survivor annuity payments must comply with percentage limitations that assure the participant won't be short-changed. A surviving spouse generally may receive up to 100 percent of the participant's annuity amount. The regulations provide tables for non-spouse beneficiaries that take into account minimum distributions incidental benefit requirements and also provide for payments consistent with existing requirements for pre-retirement spousal benefits.

If there are multiple beneficiaries, the oldest beneficiary's age generally will control death benefit payments when the contract provides for payment over the lifetime of a beneficiary. But if separate accounts are established for the beneficiaries by Dec. 31 of the year after the participant's death, each beneficiary of each separate account may use his own life expectancy.

The new regulations don't specifically mention naming a trust as death beneficiary. But because QLACs were added to existing regulations relating to RMDs, it should be possible for death benefits to be payable over the life expectancy of a trust beneficiary, provided the trust complies with the trust rules contained in Treas. Regs. Section 1.401(a)(9)-4.

Under the new regulations, a return of premium death benefit is a RMD that's due by Dec. 31 of the year when the employee (or spouse) dies. Accordingly, a return of premium death benefit may not be rolled over by a surviving spouse nor transferred by direct transfer to an inherited IRA.

Reporting

QLAC issuers must file annual reports with the IRS. The IRS will issue forms and instructions.

Plan participants are required to provide the plan administrator with annual valuations. Generally, plan administrators may rely on information provided by participants.

Plan Provisions

Employer-sponsored plans should now evaluate whether QLACs will be offered on an elective or mandatory basis and whether a plan amendment needs to be adopted to facilitate them. It will also be necessary to revise plan administration procedures to comply with reporting requirements under the final QLAC regulations.

Endnote

1. Treasury Decision 9673, 79 F.R. 37633-37643 (Jul. 2, 2014).