

Qualified Longevity Annuity Contracts

A new option to help retirement income last

In July 2014, the U.S. Treasury Department removed a significant impediment to the ability of plan participants and IRA owners to balance their use of annuities and other investments in their retirement savings arrangements, issuing final regulations that generally allow those individuals to bypass required minimum distribution (RMD) rules, which generally require that payments begin at age 70½, with respect to a portion of their total retirement savings. The regulations create a qualified longevity annuity contract, or "QLAC," a deferred annuity under which the amount of annuity payments is locked in at purchase, and those payments begin at any age up to age 85. These annuities are also referred to as deferred income annuities, or "DIAs." Of course, DIAs were available in the marketplace before these regulations; however, when they were purchased under a qualifying employer-sponsored plan or Individual Retirement Account (IRA), the annuity payments generally needed to commence by age 70½, or the individual's actual date when RMDs must commence. Thus, QLACs generally encompass such DIA contracts with income start dates after age 70½ and at or before age 85, while non-QLAC (or NQLAC) DIAs remain available for income start dates up to age 70½ in qualified employer plans or IRAs, and are not subject to the new QLAC limitations.

QLAC rules

As one would expect, QLACs are subject to important limitations, including limitations on premiums /purchase payments, cashability, and the payment of death benefits, particularly to non-spouse beneficiaries. (These requirements are not applicable to NQLACs. Instead NQLACs remain subject to the regular RMD requirements.) This paper will touch on each of the three QLAC limitations in turn.

Limits on premiums / purchase payments

- Over their lifetime, individuals cannot allocate more than \$125,000 of their qualifying retirement plan [401(a)/(k), 403(b), governmental 457(b)] and IRA (traditional; not Roth nor inherited IRAs) savings to QLACs.
- Additionally, no more than 25% of the participant's account in any one qualifying retirement plan may be allocated to purchase one or more QLACs. This limit also applies to traditional IRAs; however, rather than applying to each separate IRA, the limit applies to the aggregate of the individual IRAs. Unlike Roth IRAs, Roth accounts within retirement plans are eligible for QLACs because they are also subject to RMD requirements.
- The 25% limit applies differently to plans and to IRAs. Under a plan the 25% limit applies to the most recent valuation of the plan, and under an IRA it applies to the prior 12/31 aggregated IRA balance. In both cases the value includes the present value of any previously purchased QLAC or NQLAC under the plan or the IRAs. The plan account value is also adjusted for any subsequent contributions or distributions. It is unclear whether this same adjustment applies to the 12/31 IRA value.

Limits on cashability

QLACs generally cannot include surrender, withdrawal, or commutation features. However, contract provisions permitting a partial or total surrender to correct an excess premium or purchase payment are not considered to violate this restriction. The stated reason for this general prohibition on cashability is to maximize the amount of future benefit actually purchased, especially since these contracts are excluded from annual RMD calculations and distributions. If individuals want to purchase a similar contract with more cashability, they can still purchase an NQLAC. However, unless they are certain they will have sufficient remaining assets within the plan to cover RMDs for the plan or IRAs, taking into account the value of the NQLAC in the RMD calculations, income payments under the NQLAC should commence no later than when an individual attains age 70½.

Death benefits are permitted both before and after income payments commence, and such benefits are not considered to violate the limitations on cashability, provided that the death benefits fit within specific QLAC requirements. See Death Benefits, below.

Death benefits and benefits to individuals other than the participant/IRA owner

Death benefits prior to when income payments begin generally are limited to a return of the original premium (ROP), with no interest credited. Comments on the Treasury Department's earlier proposed regulations had noted the importance of this ROP feature to encouraging individuals to consider the QLAC options. A QLAC also may include a ROP death benefit that applies after income payments commence, upon the death of the annuitant (and, if applicable, spousal joint annuitant).

QLACs also can include payments to joint annuitants, whether or not the joint annuitant is the individual's spouse. Such payments, however, also should be life contingent, and thus the annuity cannot include the minimum guaranteed annuity period component ("period certain annuity" nor "installment refund"). Additionally, if the joint annuitant is not the individual's spouse, and if the QLAC includes a ROP death benefit prior to the commencement of income payments, then the regulations apply new limits to the non-spousal survivor annuity benefit. Additionally, a QLAC payable to a non-spouse beneficiary upon the death of the owner can include either a joint life income, or a ROP death benefit for income payments, but not both.

Additional considerations

Plan availability

Plan sponsors are generally responsible for the selection or authorization of any investments under the plan, and that includes QLACs and NQLACs. In the case of a plan subject to fiduciary rules under Title I of ERISA, that selection or authorization is a fiduciary decision. Even for non-ERISA plans, plan sponsors or fiduciaries generally must authorize the offering of either QLACs or NQLACs to plan participants. If a plan does not permit the offering of these contracts, then the plan account balance is disregarded in determining a participant's eligibility for QLAC or NQLAC purchases under other plans or traditional IRAs.

Portability

A QLAC or an NQLAC can either stand alone as an Individual Retirement Annuity, or be held under an Individual Retirement Account. Similarly, in the case of employer plans, the contract can be held under the plan as a stand-alone annuity under Code Section 403(a), 403(b), or 457(b), as applicable, or it can be held under a trust or custodial agreement under a 401(a)/(k) or 457(b) plan. A QLAC generally cannot be held under a 403(b)(7) custodial agreement.

If the QLAC or NQLAC is obtained from the plan service provider, and the employer later replaces that service provider with another service provider, the QLAC or NQLAC contract will remain with the issuing provider. However, the plan may have the option of:

- Retaining the contract as a stand-alone qualifying plan investment,
- Distributing the contract out of the plan to the participant (if the participant satisfies applicable distribution requirements), or
- If it is issued under a group annuity contract, and if the new plan is a 401(a) or 457(b) plan that would accept it, transferring the ownership of the group contract to the new plan.

If the plan is an ERISA plan, unless the contract is distributed to the participant, the plan will need to continue to maintain plan records of the contract(s) and, where applicable, incorporate relevant information into the documents and reports.

Retirement planning flexibility and other food for thought

One important consideration for many retirees, in managing their plan and retirement savings accounts, is whether those accounts might run out and leave them without sufficient retirement income in their later years. This is often referred to as “longevity risk” but also includes concerns about spending too much of that retirement savings in earlier years. Even rules of thumb for how much to withdraw each year, such as a common 4% rule, do not guarantee that individuals will not run out of money during their lifetime. The addition of QLACs and NQLACs to the tool kit can open the door to different options, including:

- Participants who have changed jobs recently, and rolled their plan account from their prior employer’s plan to an IRA, may have additional options for planning their QLAC purchases. For example, if they have already purchased the maximum QLAC from their IRAs, and if the new employer’s plan offers a QLAC option, they might decide to roll some or all of their remaining IRA balances into the new employer’s plan, rather than waiting for contributions to accumulate in the plan, to permit the desired additional QLAC purchase.

- Individuals with QLACs and/or NQLACs available can use these tools to help determine how to manage their defined contribution retirement savings, in plans and IRAs, to meet their income needs in retirement. Both QLACs and NQLACs offer the opportunity to lock in streams of income and eliminate the risk associated with potentially depleting their retirement savings by the income start date. An individual can purchase unlimited NQLACs, and/or limited QLACs, and can elect to have payments commence at different times. As just one example, a participant at age 45 might purchase an NQLAC with a lifetime income stream to commence at age 65 (or the earliest age permitted under the plan, if later), and then at age 65 purchase a QLAC to provide an additional income stream commencing as late as age 85.
- As a general matter, the amount required to provide that future stream of income can be increased or decreased depending upon:
 - How early the QLAC or NQLAC is purchased, and
 - How many additional benefits are included in the contract.

ROP death benefits and survivor annuity benefits can provide peace of mind but can also increase the cost of the income stream.

- When deciding whether to purchase the QLAC from pretax or Roth account values in the plan, participants may want to take into account any plans they have made for taking RMDs from the remaining account value from either the pretax account or the Roth account under the plan. For example, if they were planning on taking RMDs (and other earlier distributions) from nontaxable Roth account values, they may wish to purchase the QLAC from the pretax portion of the account.
- A plan that offers QLACs and/or NQLACs may be viewed more favorably by participants generally, and especially by participants who, upon leaving their employer, are deciding whether to leave their account balance in the plan or roll it to an IRA or to their new employer’s plan, if applicable. A QLAC can provide for additional retirement income planning options at later years, while an NQLAC provides many of the same benefits, though with an earlier age limit, without the RMD compliance concern of failing the QLAC purchase payment limitations.

Conclusion

QLACs, and even NQLACs, are relatively new and provide a number of interesting and exciting opportunities for individuals to explore concerning how these contracts could fit into their retirement income strategies. Because they are relatively new, the number of adopting plans may be fewer than the number of adopting IRAs, at least for the foreseeable future. The new QLAC rules bring participants yet one step closer to the kind of flexibility they may need or wish to have, to take control of the income component of their future retirement.

Tax-qualified contracts such as IRAs, 401(k)s, etc., are tax deferred regardless of whether or not they are funded with an annuity. If you are considering funding a tax-qualified retirement plan with an annuity, you should know that an annuity does not provide any additional tax-deferred treatment of earnings beyond the treatment by the tax-qualified retirement plan itself. However, annuities do provide other features and benefits such as income options including the type of lifetime income guarantees provided by a QLAC or an NQLAC.

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