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PROPOSED REGULATION TO ACCOMMODATE LONGEVITY ANNUITIES IN RETIREMENT PLANS

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BACKGROUND

In September 2009, the Internal Revenue Service (IRS) released a private letter ruling (PLR 200939018, June 18, 2009) addressing a contract in which the right to receive annuity payments and otherwise access a contract's cash value is contingent upon the annuitant living to a specified age. The ruling held that the contract was an annuity contract for purposes of section 72 of the Internal Revenue Code (the "Code"). While these types of pure deferred annuity contracts, currently known as "longevity annuities" or "longevity insurance" have long been viewed by the insurance industry as a type of annuity contract, there was a question as to whether a contract that lacked a cash value should be treated as an annuity contract for tax purposes. Ruling in the affirmative, PLR 200939018 provided a clarification from the IRS confirming the treatment of longevity annuities as a form of annuity for tax purposes, despite the absence of a cash value during the deferral period.[1]

However, the issue of the treatment of longevity annuities under the Required Minimum Distribution (RMD)[2] rules remained unsettled and the regulations applying the RMD rules have had the practical effect of limiting the offering of longevity annuities in qualified plans and traditional IRAs while the issue remained unsettled. RMDs generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 70½ years of age or, if later, the year in which he or she retires.[3] The rules require that a portion of traditional IRA and employer-sponsored plan assets be distributed over the life or life expectancy of a plan participant after that time. The rules were put in place to ensure that retirement funds are distributed rather than used as a way to avoid estate taxes.

The February 2012 report from the President's Council of Economic Advisors, "Supporting Retirement for American Families" (the "CEA Report"), observed that while the current market for longevity annuities is very small, interest in the product has been increasing. Because longevity annuities typically are purchased at or near retirement but do not begin paying benefits until considerably later, they can be offered at a fraction of the cost of annuities that pay immediate benefits, thus allowing retirees protection against the risks of extended longevity at an affordable price, while also allowing them to retain most of their wealth. The proposed regulations define a class of products knows as "qualifying longevity annuity contracts" (QLACs), which are excluded from the account balance used to determine required minimum distributions. By exempting longevity annuities (up to a specified limit) from the RMD rules, it is hoped that it will provide individuals under defined-contribution plans the option to use an "affordable" portion of their account balance to purchase a longevity annuity. The proposed regulations apply to tax-qualified defined-contribution plans under section 401(a), section 403(b), individual retirement annuities and accounts (IRAs) under section 408, and eligible governmental section 457 plans.

DEFINITION OF A QLAC

Under the proposed regulations, a QLAC is defined as "an annuity contract (that is not a variable contract under section 817, equity-indexed contract, or similar contract) that is purchased from an insurance company for an employee." However, a QLAC may also be purchased in an IRA, subject to rules discussed below.

The proposed regulations provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under the plan on a given date may not exceed the lesser of a dollar or a percentage limitation. The proposed regulations prescribe rules for applying these limitations to participants who purchase multiple contracts or who make multiple premium payments for the same contract. Under the dollar limitation, the aggregate amount of the premiums paid for QLACs under a plan may not exceed $100,000. Under the percentage limitation, the amount of the premiums paid for

CONTINUED ON **PAGE 26**

a contract under the plan may not exceed an amount equal to 25 percent of the employee's account balance on the date of payment. However, if, on or before the date of a premium payment, an employee has paid premiums for the same contract or for any other contract that is intended to be a QLAC and that is held or purchased for the employee under the plan, the maximum amount under the 25 percent limit is reduced by the amount of those other payments.

The proposed regulations would permit a QLAC to allow a participant to elect an earlier annuity starting date than the specified annuity starting date. For example, if the specified annuity starting date under a contract were the date on which a participant attains age 85, the contract would not fail to be a QLAC solely because it allows the participant to commence distributions at an earlier date. On the other hand, these rules would not require a QLAC to provide an option to commence distributions before the specified annuity starting date, so that a QLAC could provide that distributions must commence only at the specified annuity starting date. The definition of a QLAC is intended to promote affordability, focusing on maximizing the annual annuity payment relative to the premium. As a result, under a QLAC, the only benefit permitted to be paid after the employee's death is a life annuity, payable to a designated beneficiary that meets certain requirements. Thus, for example, a contract that provides a distribution form with a period certain or a refund of premiums in the case of an employee's death would not be a QLAC, as these types of benefits would add to the cost of the annuity, contrary to the purpose of providing cost-effective lifetime income to employees and their beneficiaries. Following this logic, the proposed regulations provide that if the sole beneficiary of an employee under the contract is the employee's surviving spouse, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse that does not exceed 100 percent of the annuity payment payable to the employee.

Under the proposed regulations, a QLAC would exclude variable contracts under section 817, equity-indexed contracts, or similar products, because they are seen as inconsistent with the purpose of a QLAC, which is to provide a predictable stream of lifetime income. In addition, the proposed regulation notes that exposure to equity-based returns is available through control over the remaining portion of the account balance so that a participant can achieve adequate diversification. The proposed regulations also provide that, in order to be a QLAC, consistent with the affordability concept, the contract is not permitted to make available any commutation benefit, cash surrender value, or other similar feature. As in the case of the limitations on benefits payable after death, these limitations would allow an annuity contract to maximize the annuity payments that are made while a participant or beneficiary is alive. In addition, the proposed regulation comments that having a limited set of options available to purchasers would make these contracts more readily understandable and enhance product comparability. The proposed regulations provide that a contract must be specifically identified as a QLAC at issue to ensure that the issuer, participant, plan sponsor and IRS know that the rules applicable to QLACs apply.

APPLICABILITY OF THE QLAC RULES

The QLAC rules apply to the purchase of longevity annuity contracts under tax-qualified defined-contribution plans under section 401(a) of the Code, section 403(b) plans, individual retirement annuities and accounts (IRAs) under section 408, and eligible governmental section 457 plans.

For an IRA, the QLAC requirements are applied in the aggregate. Consistent with the general limitations, the proposed regulations provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under an IRA on a given date may not exceed $100,000. If, on or before the date of a premium payment, a participant has paid premiums for the same contract or for any other contract that is intended to be a QLAC and that is purchased for the participant under the IRA or under any other IRA, plan or annuity, the $100,000 limit is reduced by the amount of those other premium payments. The proposed regulations also provide that, in order to constitute a QLAC, the amount of the premiums paid for the contract under an IRA on a given date generally may not exceed 25 percent of a participant's IRA account balances. Consistent with the rule under which a required minimum distribution from an IRA could be satisfied by a distribution from another IRA (applied separately to traditional IRAs and Roth IRAs), the proposed regulations would allow a QLAC that could be purchased under an IRA within these limitations to be purchased instead under another IRA. Specifically, the amount of the premiums paid for the contract under an IRA may not exceed an amount equal to 25 percent of the sum of the account balances (as of Dec. 31 of the calendar year before the calendar year in which a premium is paid) of the IRAs (other than Roth IRAs) that an individual holds as the

IRA owner. If, on or before the date of a premium payment, an individual has paid other premiums for the same contract or for any other contract that is intended to be a QLAC and that is held or purchased for the individual under his or her IRAs, the premium payment cannot exceed the amount determined to be 25 percent of the individual's IRA account balances, reduced by the amount of those other premiums.

Under the proposed regulations, an annuity purchased under a Roth IRA would not be treated as a QLAC. The proposed regulations would not preclude the use of assets in a Roth IRA to purchase a longevity annuity contract, nor would such a contract be subject to the same restrictions as a QLAC. For example, a longevity annuity contract purchased using assets of a Roth IRA could have an annuity starting date that is later than age 85 and offer features, such as a cash surrender right, that are not permitted under a QLAC. Although such a contract could not be excluded from the account balance used to determine required minimum distributions, this exclusion is not necessary because the required minimum distribution rules do not apply during the life of a Roth IRA owner. In addition, the dollar and percentage limitations on premiums that apply to a QLAC would not take into account premiums paid for a contract that is purchased or held under a Roth IRA, even if the contract satisfies the requirements to be a QLAC.

The proposed regulations apply the tax-qualified plan rules, instead of the IRA rules, to the purchase of a QLAC under a section 403(b) plan. For example, the 25 percent limitation on premiums would be separately determined for each section 403(b) plan in which an employee participates. The proposed regulations also provide that the tax-qualified plan rules relating to reliance on representations, rather than the IRA rules, apply to the purchase of a QLAC under a section 403(b) plan. These proposed regulations relating to the purchase of a QLAC under a tax-qualified defined-contribution plan would automatically apply to an eligible section 457(b) plan. However, the rule relating to QLACs is limited to eligible governmental section 457(b) plans. Because section 457(b)(6) requires that an eligible section 457(b) plan that is not a governmental plan be unfunded, the purchase of an annuity contract under such a plan would be inconsistent with this requirement. Although defined-benefit plans are subject to the minimum required distribution rules, they offer annuities which provide longevity protection. Because this protection is therefore already available, these proposed regulations would not apply to defined-benefit plans, but are limited to defined-contribution plan.

DISCLOSURE AND ANNUAL REPORTING REQUIREMENTS

Under the proposed regulations, the issuer of a QLAC would be required to create a report containing the following information about the QLAC:

1. A plain-language description of the dollar and percentage limitations on premiums;
2. The annuity starting date under the contract, and, if applicable, a description of the employee's ability to elect to commence payments before the annuity starting date;
3. The amount (or estimated amount) of the periodic annuity payment that is payable after the annuity starting date as a single life annuity (including, if an estimated amount, the assumed interest rate or rates used in making this determination), and a statement that there is no commutation benefit or right to surrender the contract in order to receive its cash value;
4. A statement of any death benefit payable under the contract, including any differences between benefits payable if the employee dies before the annuity starting date and benefits payable if the employee dies on or after the annuity starting date;
5. A description of the administrative procedures associated with an employee's elections under the contract, including deadlines, how to obtain forms, where to file forms, and the identity and contact information of a person from whom the employee may obtain additional information about the contract; and
6. Such other information that the Commissioner may require.

This report is not required to be filed with the IRS; however, each issuer required to create a report would be required to furnish to the individual in whose name the contract has been purchased a statement containing the information in the report. This statement must be furnished prior to or at the time of purchase. In addition, in order to avoid duplicating state law disclosure requirements, the statement would not be required to include information that the issuer has already provided to the employee in order to satisfy any applicable state disclosure law. The proposed regulations also prescribe annual reporting requirements under section 6047(d), which would require any person issu-

Under the proposed regulations, an annuity purchased under a Roth IRA would not be treated as a QLAC.

CONTINUED ON **PAGE 28**

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ing any contract that states that it is intended to be a QLAC to file annual calendar-year reports and provide a statement to the individual in whose name the contract has been purchased regarding the status of the contract. The Commissioner will prescribe an applicable form and instructions for this purpose, which will contain the filing deadline and other information.

PROPOSED EFFECTIVE DATE

The proposed regulations regarding disclosure and reporting will be effective upon publication in the Federal Register of the Treasury decision adopting these rules as final regulations. Otherwise, these regulations are proposed to be effective for contracts purchased on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register and for determining required minimum distributions for distribution calendar years beginning on or after Jan. 1, 2013. Until regulations finalizing these proposed regulations are issued, taxpayers may not rely on the rules set forth in these proposed regulations (and the existing rules under section 401(a)(9) continue to apply).

CONCLUSION

As noted in the CEA Report, the proposed regulations are intended to "remove barriers that have prevented annuity providers and plans from offering the full array of such options, bringing valuable choice to retirement savers." With the status of the longevity annuities clarified under section 72, as well as under the RMD rules, it will be interesting to see if a market develops for longevity products. One commentator has observed that "[t]here appears to be universal agreement among financial economists and pension actuaries about the substantial social welfare benefits from payout (or immediate) annuity contracts. But the public and the media have yet to embrace this risk management instrument as being equally important as a well-diversified retirement portfolio of stock and bonds."[4] That is, the challenge that the life insurance industry faces is that, despite the arguments of the economists, the vast majority of retirees are unwilling to annuitize all of their assets. For a variety of reasons, the public has not embraced payout annuities as a financial solution to bridging the gap between accumulating wealth and guaranteeing retirement income payments, although many industry studies point to "consumers' reluctance to relinquish complete control over their assets by making such a purchase."[5] Whether the current initiative of the Obama administration to encourage the use of longevity products will succeed remains to be seen. However, it does provide the industry with an opportunity to offer a product solution to the challenge of providing sustainable retirement income. ◀

The views expressed are those of the author and not of Ernst & Young LLP.

END NOTES

1 *See* McKeever and Garcia, "IRS Rules Longevity Contract is Annuity under Section 72," *TAXING TIMES* February 2010, 14.

2 The RMD rules apply to all employer-sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans and 457(b) plans. Stock bonus, pension and profit-sharing plans qualified under section 401(a) and annuity contracts described in section 403(a) are subject to required minimum distribution rules under section 401(a)(9). The RMD rules also apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs and SIMPLE IRAs under sections 408(a)(6) and 408(b)(3). Deferred compensation plans for employees of tax-exempt organizations or state and local government employees are subject to required minimum distribution rules under section 457(d)(2).

3 However, if the retirement plan account is an IRA or the account owner is a 5 percent owner of the business sponsoring the retirement plan, the RMDs must begin once the account holder is age 70½, regardless of whether he or she is retired.

4 Moshe Milevsky, "Real Longevity Insurance with a Deductible: Introduction to Advanced Life Delayed Annuities (ALDA)," *North American Actuarial Journal*, Volume 9, No. 4, 109.

5 Rob Stone, "Longevity Insurance: An Answer to a Difficult Retirement Planning Question," *NAVA Outlook*, December 2006, 1.