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FINAL REGULATIONS PAVE THE WAY FOR "QLACs"

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Some time ago, the U.S. Treasury Department discovered that participants in qualified defined-contribution plans and individual retirement accounts (IRAs) could outlive their income. Life insurance companies have long marketed annuity contracts as sound retirement planning instruments in the nonqualified market, pointing to the assurance of income for as long as the annuitants survive, and they have provided annuity promises in section 403(b) plans and 408(b) IRAs. However, annuity contracts have not been a universal feature of such popular arrangements as section 401(k) plans and section 408(a) IRAs. The absence of the lifetime income promise, unique to insurer-issued annuity contracts, from the latter types of retirement arrangements began to worry the Treasury, as the absence of any such promise carries negative implications for Americans' retirement security. This is especially true in that defined-contribution plans have steadily replaced the prominent role that defined-benefit plans once held in our private retirement system.

In February of 2010, the Treasury, accompanied by the Internal Revenue Service (IRS) and the Department of Labor, published a request for information on how to facilitate greater availability of lifetime income options in qualified retirement plans (including IRAs). In particular, the request asked for comments on whether changes to the required minimum distribution (RMD) rules under IRC section 401(a)(9) should be made to encourage plan participants to "purchase deferred annuities that begin at an advanced age (sometimes referred to as longevity annuities or longevity insurance)." In response, the life insurance industry and others urged the government to amend those rules to remove impediments to offering deferred income annuities (DIAs) in the qualified market. The typical DIA, unlike a modern deferred annuity contract, provides no cash surrender value (except possibly for a return of premium (ROP) on premature death), but the DIA promises life-contingent annuity payments commencing at a specified age, an option available under all deferred annuities. In this respect, the DIA is a bit of a throwback to earlier times, when insurers sold deferred annuities that lacked surrender values.

Responding to these suggestions, in 2012 the Treasury and the IRS published proposed regulations modifying the RMD rules with this goal in mind.[1] The proposal, which technically was in the form of amendments to the IRC section 401(a)(9) regulations, created a new species of tax critter, the "qualifying longevity annuity contract" or "QLAC." At base, under the proposal, a QLAC is a form of DIA that provides no cash surrender value as such and under which fixed, life-contingent annuity payments are promised, commencing at a specified age not later than 85. These regulations, subject to a number of changes, were issued in final form on July 1, 2014, effective the next day (when they were published in the Federal Register), and applicable to contracts purchased on or after July 2, 2014. The final regulations, as amended, appear in Treas. Reg. section 1.401(a)(9)-5 and -6 as well as in related rules.

WHY QLACs?

Some background on IRC section 401(a)(9) and the regulations implementing it is likely in order at this point. Those rules require that distributions of a participant's entire interest in a qualified retirement plan or IRA commence by the participant's "required beginning date," which is generally age 70½. For individual accounts under a defined-contribution plan (including an IRA), the RMD is calculated by dividing the employee's account balance by a life expectancy factor. For this purpose, the account balance of a deferred annuity contract (such as a deferred annuity issued as an IRA) includes the actuarial present value (APV) of certain benefits that are not reflected in the contract's cash value. Because a DIA providing for payments commencing at (say) age 85 obviously has a significant APV but is without a cash value, the APV requirement effectively precluded such a contract from being offered in the qualified plan and IRA markets, since the contract lacked the means to provide RMDs between age 70½ and age 85.

To remedy this conundrum, enabling a qualified plan or IRA to hold a DIA in the form the government deemed appropriate,

the QLAC was born. As amended in July 2014, the RMD rules permit the ownership of a QLAC. Under the final regulations, the value of a QLAC held under a plan or IRA (other than a Roth IRA) is excluded from the account balance used to determine RMDs, meaning that no RMDs would be required with respect to the contract prior to annuity payments commencing thereunder.

WHAT IS A QLAC?

In order to be a QLAC under the final regulations, a contract is required to:

1. Be a commercial, fixed annuity that states in a prescribed manner that it is intended to be a QLAC (see the discussion of "form" and a transition rule below);

2. Limit premiums to the lesser of 25 percent of the participant's account balance or $125,000, indexed for inflation in $10,000 increments;

3. Specify an annuity starting date (ASD) that occurs by (or shortly after) the participant's age 85;

4. Provide no cash surrender value, commutation benefit, or other similar feature;

5. Provide annuity payments that otherwise comply with the applicable RMD rules; and

6. Limit any death benefits provided to certain forms of survivor annuity payments or to a lump-sum ROP within certain limits.

The final regulations also set forth certain disclosure and annual reporting requirements applicable to QLACs. Some detail on this list of requirements follows, in the order of the requirements just listed.

Form. The final regulations require a QLAC to state, on its face or in a rider or endorsement (or in a group contract certificate), that it is intended to be a QLAC. Since DIA contract forms otherwise complying with the QLAC rules will need to undergo an amendment process to implement this requirement, the final regulations include a transition rule addressing them. Pursuant to this rule, a contract issued before Jan. 1, 2016, that does not comply with this form requirement will nonetheless be treated as complying if it is amended to comply by the end of 2016 and the contract owner was notified at issuance that the contract was intended to be QLAC.

Premium limits. The premium limits are subject to certain aggregation rules. The $125,000 limit measures premiums paid for QLACs in all qualified retirement arrangements in which the individual participates—employer-sponsored plans, IRAs, etc. The 25 percent limit applies separately to employer plans and IRAs, but for this purpose all the IRAs that an individual owns are aggregated when applying the limit. In response to industry comments, the final regulations also provide a mechanism for correcting excess premium payments, *i.e.*, by returning them to the participant's account by the end of the following year. This can be accomplished by returning the excess premium in cash or as an annuity contract that is not intended to be a QLAC. Premiums paid for a noncompliant QLAC (other than one that fails the premium limits) do not count toward the premium limits applicable to QLACs. Further, for purposes of applying the 25 percent limit, the regulations provide that the value of a QLAC is included in the account balance even though it is otherwise disregarded in applying the RMD rules, thus eliminating a technical problem that could have arisen in the case of QLACs purchased with multiple premiums. In addition, the regulations say that the 25 percent limit is applied to the account balance as of the last valuation date preceding the date of a premium payment, adjusted for subsequent contributions and distributions. For IRAs, the 25 percent limit is applied to the prior year-end account balance of all the individual's IRAs.

Death benefits. As noted above, under the final regulations a QLAC (to be a QLAC) must limit any death benefit it provides to (1) life-contingent survivor payments or (2) a lump sum ROP. For spousal beneficiaries, the regulations allow a QLAC to provide both a survivor annuity and an ROP benefit, but for non-spouse beneficiaries only one or the other is allowed. If a QLAC provides for a survivor annuity to a non-spouse beneficiary in lieu of a lump sum ROP, the contract must either provide no benefit at all if the participant dies before the ASD or the beneficiary must be irrevocably elected by the later of the participant's required beginning date or the date the QLAC is purchased. In either case, the survivor annuity payments to the non-spouse beneficiary must be reduced by a factor prescribed in one of two tables set forth in the regulations. If an ROP death benefit is payable to a spouse or non-spouse beneficiary, it must be distributed from the plan or IRA by Dec. 31 of the year following death. Further, if the

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participant (or spouse) dies after his or her required beginning date, the ROP death benefit is treated as an RMD for the year in which it is paid and is not eligible for rollover, meaning that it will be forced out and be taxable to the beneficiary.

Disclosure requirements. The final regulations require QLAC issuers to file annual calendar-year reports with the IRS and provide a statement to the participant regarding the contract's status, including in the reports the fair market value of the QLAC. The preamble to the final regulations states that the annual reporting requirement "will be similar to the annual requirement to provide a Form 5498, 'IRA Contribution Information,' in the case of an IRA." The IRS has released a new reporting form, Form 1098-Q, "Qualifying Longevity Annuity Contract Information." According to the new form, the QLAC issuer is to send the form to the participant beginning with the first year in which premiums are paid for the QLAC and ending with the year in which the participant attains age 85 or dies (whichever is earlier).

THE LIMITATION TO FIXED ANNUITIES

The final regulations, like the proposed regulations before them, prohibit the use of a variable annuity, indexed annuity, or similar contract as a QLAC. The life insurance industry had asked, in commenting on the proposed rules, that such products be allowed, for example, to provide a guaranteed "floor" of payments with the potential for increases based on mortality or investment gains (or expense savings), a specified index, or a referenced pool of assets. Although the final regulations allow QLACs to be structured as participating contracts or to provide for certain cost-of-living increases in payments, they largely punted on the use of variable or indexed annuities by retaining the general prohibition against their use as QLACs but delegating authority to the IRS to publish guidance with exceptions to that prohibition.

Why such a prohibition? The preamble to the final regulations explains that the Treasury and IRS believe that QLACs should provide "a predictable stream of lifetime income" and that variable annuities and indexed annuities "provide a substantially unpredictable level of income ... even if there is a minimum guaranteed income." The preamble also points to a desire for "a limited set of easy-to-understand QLAC options" to improve "the ability of employees to compare the products of multiple providers." Of course, variable annuities and indexed annuities can be structured to provide a "predictable stream of lifetime income," so it may just be a matter of the industry continuing to educate the government on this fact, enabling the IRS to publish the guidance that the regulations suggest may be forthcoming.

STILL MORE TO COME?

The final regulations enabling the issuance of DIAs as QLACs take a major step in the right direction, enabling qualified defined-contribution plans and IRAs to provide an income to participants and their beneficiaries that they cannot outlive. The regulations, however, do not reach an even older style of retirement plan—the defined-benefit pension plan. The Treasury, to its credit, is aware that the purchase of DIAs could benefit such plans as well. To this end, the preamble to the final regulations requests comments on "the desirability of making a form of benefit that replicates the QLAC structure available in defined benefit plans," and particularly on "the advantages to an employee of being able to elect a QLAC structure under a defined benefit plan, instead of electing a lump sum distribution from a defined benefit plan and rolling it over to a defined contribution plan or to an IRA in order to purchase a QLAC." Hence, there may be more to come on the QLAC story. The Treasury, apparently, is still worried, but maybe not quite as much as before. ◄

END NOTES

1 See also Christian DesRochers, "Proposed Regulation to Accommodate Longevity Annuities in Retirement Plans," *Taxing Times*, Vol. 8, Issue 2, May 2012.