WRMarketplace
An AALU Washington Report

Thursday, August 14 2014 **WRM# 14-32**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

Topic: Qualifying Longevity Annuity Contracts – An Opportunity: Providing Longevity Risk Protection in Retirement Plans and IRAs.

MARKET TREND: The Concern: With increased longevity and low interest rates, the prospect of running out of retirement funds is very real. A Solution: Qualifying Longevity Annuity Contracts ("QLACs"), which can offer some protection against that risk and may be particularly useful for certain investors inside their retirement accounts and IRAs.

SYNOPSIS: Internal Revenue Code ("**Code**") §401(a)(9) requires that participants in various retirement arrangements, including IRAs, take minimum required distributions ("**MRDs**") when the participants reach a certain age. As these distributions generally begin around age 70½, they can exacerbate longevity risk. The IRS and Treasury recently released final regulations under Code §401(a)(9) providing that the calculation of MRDs will not take into account QLACs if various conditions are satisfied. In these cases, QLACs can be useful tools for participants in retirement plans and IRAs. Due to fiduciary concerns and unanswered questions concerning portability of QLACs, however, these annuities may initially be more prevalent in the IRA market than in the employer plan market.

TAKE AWAYS: Advisors to employers sponsoring defined contribution plans and, particularly, to individuals holding IRAs should familiarize themselves with the rules governing QLACs so that they can assist their clients in making these vehicles available, when suitable, as well as making appropriate investments in them when offered.

MAJOR REFERENCES: *Treas. Regs. §§ 1.401(a)(9)-5 and 1.401(a)(9)-6; Correction to Final Regulations.*

As life expectancies increase, so do individuals' concerns that they might outlive their assets. One option is to purchase a longevity annuity, which provides for the distribution of a stream of payments starting at a delayed date. The use of these annuities, however, is constrained in the context of retirement plan or IRA assets by the application of the MRD rules of the Code. Under recently issued final regulations, however, longevity annuities that meet the requirements for being considered QLACs are disregarded in applying the MRD rules. Due to unanswered questions concerning portability of QLACs and concerns about fiduciary liability in connection with the offering of QLACs under an ERISA plan, the market for these products may initially be stronger for IRAs than with tax-qualified employer retirement plans or tax-sheltered annuities.

BACKGROUND

Tax-qualified plans under Code § 401(a), tax-sheltered annuities under Code §403(b), eligible deferred compensation plans under Code § 457(b) and IRAs are subject to the MRD rules established under Code §401(a)(9) and applicable regulations. Under these rules, distributions typically must commence to a participant by April 1 of the year following the year in which the participant attains age 70½ (although, in the context of an employer-maintained plan, as opposed to an IRA, distributions to employees who are not 5% owners do not have to begin before the employee has retired).

Generally, the amount of the MRD to a participant for any year is determined by dividing the value of participant's retirement account by the participant's then-current life expectancy (or joint life expectancy, or deemed life expectancy, of the participant and his designated beneficiary). To determine the value of the participant's account, the value of any annuity contract that has not yet been annuitized is included in the participant's account balance. If, however, the annuity contract is a QLAC, the value of the contract is excluded in determining the participant's account balance and, therefore, the amount of the MRD payable for any year.

REQUIREMENTS FOR QLACS

Under recently issued final regulations, the IRS established specific criteria for annuity contracts to qualify as QLACs.

1. **Latest Commencement Date.** The annuity must commence no later than the first day of the first month following the participant's attainment of age 85 (this age may be adjusted in future years to reflect changes in mortality).

2. **Limitations on Premium Payments.** The amount of premiums paid for the contract cannot exceed the ***lesser*** of $125,000 and 25% of the participant's account balance (the dollar threshold may be increased in future years to reflect inflation).

   This limit is an aggregate limit that applies to all defined contribution plans and IRAs of the individual.

   If an annuity contract fails to satisfy the premium limit, the contract will still be considered a QLAC if the ***excess premium is returned to the participant's account*** by the end of the year after the year in which the excess premium was paid.

3. **Death Benefits.** A QLAC may, but is not required to, include a return-of-premium ("**ROP**") feature. Under this feature, a single-sum death benefit equal to the amount by which the premiums paid exceed the amount of the annuity payments that have been made can be paid to a beneficiary after the death of the participant, or, if an annuity is being provided to the participant's surviving spouse, after the death of the participant and the surviving spouse. This ROP payment must be made no later than the last day of the calendar year following the calendar year of the death of the person triggering the ROP payment.

   If an annuity contract does not include a ROP feature, the only death benefits that may be provided are those under a life-contingent annuity with a designated beneficiary, subject to limitations on amounts set forth in the final regulations and consistent with other aspects of the MRD rules.

4. **Designation as a QLAC.** The annuity contract or ancillary document must state that the contract is intended to be a QLAC. This rule will be treated as satisfied if contracts are amended to comply with it by the end of 2016 and employees are notified of the intention to be a QLAC at the time of contract issuance.

5. **Certain Features Prohibited.** A QLAC may not include a variable annuity, an indexed contract, or a similar contract. A QLAC may, however, be a participating annuity contract that pays to the holder dividends or amounts resulting from actuarial gains or may provide for certain cost-of-living increases. Likewise, a QLAC may not offer any commutation benefit, cash surrender alternative or similar feature.

6. **Reporting and Disclosure**. QLAC issuers are required to file annual calendar-year reports with the IRS. In addition, they must provide a statement to the contract owner regarding its status. The IRS will be issuing a new form to be used for this purpose.

7. **Available Only for Defined Contribution Arrangements.** Because defined benefit pension plans and similar arrangements are generally structured to offer payment in the form of a life annuity or joint-and-survivor annuity, participants are thought not to need the protections afforded by longevity annuities. ***Thus, defined benefit plans will not be eligible to hold QLACs***.

IMPORT FOR PLANS AND PARTICIPANTS

Opportunity for Longevity Management. These new final regulations for QLACs held under defined contribution arrangements provide a meaningful opportunity for certain plan participants and IRA holders to acquire some insurance against the risk of outliving their assets. Given the overall cap on premium payments for QLACs of $125,000, however, these contracts likely will not be of much interest to very high net worth individuals.

Issues for Employer Plans. There are two main issues that increase the likelihood that QLACs will be more prevalent in the IRA market than in the employer-plan market.

Fiduciary Responsibility in Selection. One issue is the fiduciary responsibility associated with selecting the QLAC provider who will provide the QLACs made available under a plan. As these contracts will be investments offered under the plan, the plan's investment fiduciaries are subject to fiduciary responsibility under ERISA to ensure that the particular QLAC offered is a prudent investment alternative to make available to plan participants. Plan fiduciaries would need, at a minimum, to evaluate the contract features and pricing, as well as the financial strength of the insurer offering the contracts. Some employers may be unwilling to take on this risk. Those who regularly engage in a similar process of evaluating the suitability of the other investments offered under the plan, however, may feel comfortable modifying their current investment monitoring process to encompass QLACs. In any event, this issue does not come into play in the context of investing IRA assets in a QLAC.

QLAC Portability. The second issue relates to the portability of QLACs. A plan participant likely will want to transfer a QLAC held in an employer plan to another employer plan or to an IRA if he or she leaves employment with the first employer. Unfortunately, the final regulations do not specifically address this aspect of QLAC investments and, in particular, the manner in which the transfer of a QLAC would be taken into account for purposes of the percentage-of-account-balance limits on premium payments. The IRS may provide additional guidance that covers this issue, but, until that time, the uncertainty may limit qualified plan investment in QLACs. Investment of IRA assets in these contracts, however, should be relatively unaffected by this issue, since individuals do not generally transfer money from one IRA to another IRA.

TAKE AWAYS

- Advisors to employers sponsoring defined contribution plans and, particularly, to individuals holding IRAs should familiarize themselves with the rules governing QLACs so that they can assist their clients in making these vehicles available, when suitable, as well as making appropriate investments in them when offered.

The AALU *WRNewswire* and *WRMarketplace* are published by the Association for Advanced Life Underwriting® as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation's most advanced life insurance professionals.

WRM #14-32 was written by Greenberg Traurig, LLP
Jonathan M. Forster
Martin Kalb
Richard A. Sirus
Steven B. Lapidus
Rebecca Manicone

Counsel Emeritus
Gerald H. Sherman 1932-2012
Stuart Lewis 1945-2012