July 2, 2014

Summary of Final QLAC Regulations

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On July 1, 2014, the IRS and Treasury Department released final regulations on the treatment of qualifying longevity annuity contracts, or QLACs, under the required minimum distribution (RMD) rules of Internal Revenue Code section 401(a)(9).

These regulations implement a suggestion the SPARK Institute made in 2010 in response to the Obama Administration's Request for Information on lifetime income options. In our 2010 letter, we suggested that Treasury issue a "waiver" of the RMD rules for a lifetime payout starting at an advanced age at or near life expectancy to encourage people to provide for a means to avoid outliving their assets. Many others in the retirement industry supported this concept.

Summary

The final regulations provide an exception to the RMD rules, allowing a defined contribution, 403(b), or 457(b) plan participant or IRA owner to use a portion of his or her account to purchase a deferred income annuity (DIA) that provides no cash value and under which annuity payments commence at a specified age, no later than 85. This product would provide protection against the longevity "risk" that the retiree will outlive his or her (other) assets. Absent these rules, a DIA could cause the account to run afoul of the RMD rules because it does not begin payments until after age 70 ½. The offering of a QLAC is optional for a plan sponsor.

These regulations are part of an ongoing effort at the Treasury Department and IRS (and the Department of Labor) to facilitate innovative solutions to the challenge of helping retirees manage their savings in retirement. Treasury and IRS published proposed regulations in 2012, and comment letters submitted in response from the insurance industry were generally positive.

The final regulations adopt several suggestions made by the insurance industry. For example, the final regulations allow QLACs to provide return of premium death benefits, increase the premium limits that can be paid for QLACs, and address "foot faults" in applying those limits. The final regulations do not allow, as the industry had requested, variable annuities and fixed indexed annuities to be issued as QLACs or allow QLACs to provide cash values.

The regulations are effective on July 2, 2014 and apply to contracts purchased on or after that date.

Background

Section 401(a)(9) and the regulations thereunder provide that distributions of an employee's entire interest in a qualified retirement plan, 403(b) plan, 457(b) plan, or IRA must commence by his or her "required beginning date." For individual accounts (*i.e.* not annuitized benefits) the RMD is calculated by dividing the employee's account balance by a life expectancy factor.

When a plan account or IRA holds a deferred annuity, the account balance must include the actuarial present value (APV) of certain benefits that are not reflected in the annuity's cash value. In the case of a DIA, which may have no surrender cash value, the APV requirement effectively precluded such contracts from being offered in the qualified plan and IRA markets. This is because prior to the annuity payments commencing under a DIA, the contract has a significant APV but no cash value from which to make the RMD payments. As a result, the only DIAs that have typically been offered in the IRA and plan markets have been those providing for annuity payments that commence on or before the owner's required beginning date, generally age 70½.

On February 3, 2012, Treasury and IRS released proposed amendments to the section 401(a)(9) regulations (and various related regulations) that would facilitate the purchase of DIAs providing annuity payments that commence at more advanced ages, as long as the contract meets the definition of a QLAC in the regulations. Under the proposed regulations, the value of a QLAC held under a plan or IRA (other than a Roth IRA) would be 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. In order to be a QLAC under the proposed regulations, a contract would have been required to:

- be a commercial, fixed annuity that states it is intended to be a QLAC;
- limit premiums to the lesser of 25% of the employee's account balance or $100,000;
- specify an annuity starting date (ASD) that occurs by age 85;
- provide no cash surrender value, commutation benefit, or other similar feature;
- provide annuity payments that otherwise meet the applicable RMD rules for annuities; and
- limit death benefits to certain forms of survivor annuity payments.

The proposed regulations also set forth certain disclosure and annual reporting requirements applicable to QLACs. A summary of the changes made by the final regulations follows.

Premium Limits

The proposed regulations would have limited the premiums that could be paid for QLACs to 25% of the owner's account balance or $100,000, whichever is less. The final regulations <u>increase the dollar limit to $125,000 but retain the 25% limit</u>.[1] The final regulations also make the following changes:

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[1] The $125,000 aggregate premium limit applies to all plans and IRAs for that individual. The 25% limit, on the other hand, applies on a plan by plan basis. (With respect to IRAs, the 25% applies to all IRAs held by the individual.)

- Clarify that premium "foot faults" will not necessarily disqualify a QLAC. The final regulations provide a mechanism for correcting excess premiums by returning them to the individual'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, although the regulations do not elaborate on the latter method. If excess premiums are not returned by the deadline, the entire QLAC (not just the excess portion) is disqualified as of the date of the excess premium. In addition, the individual's account balanced is increased by any excess premium that is not returned by the last valuation date for the year in which it was paid.

- Clarify that the value of a QLAC is included in the account balance for purposes of applying the 25% limit, even though the QLAC's value is otherwise ignored when applying the RMD rules. This change eliminates a technical problem that could have arisen with the 25% limit as applied to QLACs purchased with multiple premiums.

- Clarify that the 25% limit is applied with respect to the individual's account balance as of the last valuation date preceding the date of a premium payment, adjusted for subsequent contributions and distributions.

- Clarify that premiums paid for a non-compliant QLAC (other than one that fails the premium limits) do not count towards the premium limits applicable to QLACs.

- Provide that the dollar limitation on premium payments will be indexed for inflation in $10,000 increments, rather than $25,000 increments.

Death Benefits

The proposed regulations would have limited death benefits under QLACs to life-contingent survivor payments. The insurance industry had expressed concern that it is difficult to convince individuals to purchase a deferred annuity without some death benefit that, at a minimum, returns back to beneficiaries the premiums paid to the insurer. The final regulations allow return of premium (ROP) death benefits both before and after the annuity starting date (ASD), so long as such death benefits are distributed from the IRA or plan no later than the end of the calendar year following the calendar year in which the employee dies, or in which the surviving spouse dies, whichever is applicable. They also clarify that if the individual dies after his or her required beginning date, the ROP death benefit is treated as a required minimum distribution for the year in which it is paid and is not eligible for rollover. This means the ROP death benefit will be forced out and taxable to the beneficiary.

Other than a lump sum ROP death benefit, the final regulations retain the approach in the proposed regulations that the only type of death benefit permitted under a QLAC is in the form of a life-contingent survivor annuity. With respect to non-spouse beneficiaries, the proposed regulations would have prohibited QLACs from providing a survivor annuity if the owner dies after the ASD unless the contract (1) provides no pre-ASD survivor benefit or (2) the non-spouse beneficiary was irrevocably elected before the owner's required beginning date. The final regulations retain this rule, but clarify that the irrevocable election can be made until the *later* of the owner's required beginning date or the date the QLAC is purchased (rather than by the owner's required beginning date). This addresses a problem that could have arisen for QLACs purchased after the required beginning date.

Variable and Indexed Annuities Not Allowed

The proposed regulations provided that a variable annuity, indexed annuity, or similar contract cannot be used as a QLAC. The final regulations reject suggestions to allow these products, but allow QLACs to be structured as participating contracts or to provide for certain cost-of-living increases in payments. The final regulations also provide that the IRS can issue guidance with exceptions to the prohibition against variable and indexed annuities as QLACs.

In addition, the final regulations retain the rule that the annuity payments made under a QLAC must otherwise comply with the existing RMD rules applicable to annuity payments. Those existing rules generally allow for increasing annuity payments only if certain requirements are met, including a requirement that the "total future expected payments" must exceed the "total value being annuitized." Thus, a QLAC can include dividends otherwise allowed for annuity payments under the current RMD rules.[2]

Cash Value and Similar Features Not Allowed

The proposed regulations stated that a QLAC cannot provide a cash value, commutation right, or similar benefit. The final regulations retain the approach in the proposed regulations. The preamble explains that the reason for prohibiting cash value features is that they "would significantly reduce the benefit of mortality pooling under the contracts."

Form Requirements

The proposed regulations would have required a QLAC to state, on its face, that it was intended to be a QLAC. The final regulations soften this requirement somewhat, allowing the statement to be included in a rider or endorsement, or in a certificate issued under a group contract. The final regulations also include a transition rule under which a contract that is issued before January 1, 2016, and does not comply with these form requirements will nonetheless be treated as complying if it is amended to comply by the end of 2016 and the owner was notified at issuance that the contract was intended to be QLAC.

Disclosure Requirements

The final regulations retain the requirement that QLAC issuers must file annual calendar-year reports with the IRS and provide a statement to the QLAC owner regarding the contract's status. The final regulations also clarify that the annual reports must include the fair market value of the QLAC. The preamble states that the annual reporting requirement will be similar to the annual requirement to provide a Form 5498 with respect to IRAs. The IRS will prescribe a new form and instructions to use for this purpose.

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[2] *See* Treas. Reg. § 1.401(a)(9)-6, Q&A-14. These rules are designed to allow limited increasing payments while preventing back loading of annuity payments to defer taxation. Some insurers have found recently that historically low interest rates and dated IRS mortality tables can cause annuities with certain kinds of increasing payments to violate the rules.

The final regulations also eliminate a requirement to provide an initial disclosure statement to a covered employee "in light of the existing disclosure practices that take into account disclosure requirements under state law and under Title I of ERISA."

Section 403(b) and 457(b) Plans

Both 403(b) and 457(b) plans are subject to the RMD rules, and the regulations provide an exception for QLACs purchased under these plans. Generally, the QLAC qualified plan rules, and not the IRA rules, apply. Thus, for example, the 25% limitation applies to each 403(b) plan in which an individual participates. In addition, similar to qualified plans, a life annuity that is payable to the surviving spouse after the employee's death is permitted to exceed the annuity that would have been payable to the employee to the extent necessary to satisfy the requirement to provide a qualified preretirement survivor annuity (QPSA). Some 403(b) plans subject to ERISA may be required to offer a QPSA.

Under the final regulations, only governmental 457(b) plans, and not 457(b) plans of non-governmental tax-exempt entities, may offer a QLAC. All 457(b) plans are subject to the RMD rules, but a non-governmental 457(b) plan must be unfunded. Treasury states that the purchase of an annuity contract under such a plan would be inconsistent with the requirement that such a plan be unfunded.

Defined Benefit Plans

The final regulations do not apply to defined benefit plans. However, the preamble 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."