Legal Developments

New Investment Opportunity for Defined Contribution Plans—Qualifying Longevity Annuity Contracts (QLACs) Are Here

In an effort to help prevent retirees from outliving their retirement savings, the IRS and the Treasury Department finalized new rules that allow participants in defined contribution plans to invest in "longevity annuities" that do not violate the complex minimum required distribution (MRD) requirements, which otherwise mandate that participants start taking plan distributions upon reaching age 70½. These complex new rules, which were first introduced in 2012, are set forth in Treasury Regulations Section 1.401(a)(9)-6, and are briefly summarized below.

By Elizabeth T. Dold

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Background

In recent years, in response to growing concerns about the possibility of retirees "outliving" their investments, insurers have started offering a line of deferred annuities commonly known as "longevity" contracts. Unlike traditional annuities, distributions from longevity contracts typically do not begin until a relatively late age, usually 80 or 85, and thus offer retirees added security in case they exhaust their other retirement investments—such as by "living too long" or experiencing a major market downturn. Notably, because longevity contracts provide for late distributions and often do not have cash values or "refund" features, they are considerably less costly than traditional annuities.

Despite understandable interest from retirement planners, the use of longevity contracts in IRA, 401(k), and other tax-favored retirement accounts has been frustrated by a regulatory obstacle: the MRD rules. In very broad terms, the MRD rules require that participants start taking annual distributions from their retirement accounts once they reach age 70½. Before release of the final rules, the IRS required that the value of any longevity contract be included as part of a participant's account balance for MRD calculation purposes. This presented several problems: if participants depleted their account balances—for instance, by outliving their investments or due to a severe market decline—participants would be required to begin receiving distributions from the longevity contract, even if the timing of the distributions was much earlier than desired. Alternatively, if participants decided to simply not include the value of any longevity contract as part of their account balance, they risked incurring substantial penalties, including a 50 percent annual excise tax on the "shortfall," as well as possible plan disqualification.

The final regulations provide relief from this "catch-22" situation by allowing participants to exclude the value of a longevity annuity contract for MRD purposes as long as the annuity meets the definition of a "qualifying longevity annuity contract" (QLAC), which is described below. However, the remainder of the MRD rules continues to apply.

Definition of QLAC

To be eligible for this limited MRD exception, the annuity must be purchased on or after July 2, 2014, and meet several rather strict requirements.

First, not all types of plans are eligible for this limited MRD exception. Only defined contribution plans (including 401(k) and profit-sharing plans), traditional IRAs, 403(b) plans, and governmental 457(b) plans are eligible to hold QLACs.

Second, there is a limit to the total premium on the annuity. Specifically, the total premium limit cannot exceed the lesser of $125,000 (indexed for inflation) or 25 percent of a participant's aggregate account balance. Although the value of a QLAC is excluded for MRD purposes, the value must be included in the account balance when applying the 25 percent limit. The premium limitation is applied as of the last plan valuation date preceding the premium payment, increased by contributions, and decreased by distributions made after the valuation date but before the date the premium is paid. Notably, the final regulations provide a correction process if the premium limit is exceeded. If the limit is exceeded, the excess must be returned to the participant's non-QLAC account by the end of the calendar year following the year of the payment; otherwise, the annuity will no longer be a QLAC.

Third, there is a maximum age to commence payments under the annuity. The maximum age at commencement of QLAC is currently set at age 85. The QLAC must provide that distributions will not start later than a specified annuity starting date set forth in the contract. The contract can permit a participant to elect an earlier annuity starting date, but the specified annuity starting date cannot be later than the first day of the month following the participant's 85th birthday (as adjusted for changes in mortality).

Fourth, there must be specific language in the contract identifying it as a QLAC. The contract, rider, or endorsement (or certificate for a group annuity) must indicate that the annuity is intended to be a QLAC. Importantly, the final regulations provide a "transition rule" that any contract issued before January 1, 2016, will not be disqualified for not including such language as long as the participant was notified (upon issue) that it was intended to be a QLAC, and as long as the contract (or other appropriate document as identified by the regulations) is amended to include the QLAC language by December 31, 2016.

Fifth, there are restrictions on certain contract features. For example, a participation feature is permitted, but the following features are currently prohibited: a variable contract under Code Section 817, an indexed contract, or similar contract. Moreover, the QLAC cannot provide any commutation benefit, cash surrender value, or other similar feature. There are also restrictions on the death benefits available under a QLAC. The QLAC may provide that, in case the annuitant dies before recovering the full amount of premium payments, the total payments received will be at least equal to total premiums paid. This is the only lump-sum death benefit permitted to be paid from a QLAC. The QLAC also may provide for a life annuity survivor benefit to a surviving spouse, as long as it does not exceed (1) 100 percent of the annuity payable to the participant, or (2) the plan's qualified preretirement survivor annuity. If the participant dies before the specified annuity starting date, the surviving spouse must commence benefits by such date. For a non-spouse beneficiary, the death benefit is limited to a life annuity that meets the special incidental death benefits. If the participant dies before the specified annuity starting date, the annuity must commence by the last day of the calendar year immediately following the calendar year of the participant's death.

Sixth, QLACs are subject to annual reporting requirements. Beginning with the first year a QLAC premium is paid, an annual report must be provided to both the participant and the IRS, which includes the following information: contact information for both the issuer and the participant; information about the plan and plan sponsor (if any); if payments have not yet commenced, the annuity starting date, the amount of the payment, and whether the starting date may be accelerated; the amount and date of each premium paid during the calendar year; the total amount of premiums paid through the end of the calendar year; and the fair market value of the QLAC as of the close of the calendar year.

Conclusion

These complex rules are the first step in facilitating the use of longevity contracts in tax-favored defined contribution plans as a means to help decrease the investment and longevity risks that participants are faced with. Time will tell how well these more traditional annuity products will be received by plan sponsors and participants. ■