

Qualifying Longevity Annuity Contracts

Frequently Asked Questions (FAQs)



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INTRODUCTION

On July 1, 2014 the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued **final regulations** regarding longevity annuities, making them accessible to the defined contribution (DC) and individual retirement account (IRA) markets. Prior to the issuance of these regulations, longevity annuities were, as a practical matter, not accessible to DC and IRA investors. Section 401(a)(9) of the Internal Revenue Code requires distributions from a DC or IRA account to begin by age 70 ½, prior to the age longevity annuities are designed to begin income payments. With the new regulations, qualifying longevity annuity contracts (QLACs) are exempt from required minimum distribution (RMD) rules within prescribed parameters.

These final regulations follow **proposed regulations** that were published on February 3, 2012. They also incorporate written and oral testimony received from the Defined Contribution Institutional Investment Association (DCIIA), its members, and other industry leaders at a Public Hearing on June 1, 2012.

DCIIA applauds Treasury's focus on this topic and anticipates that the new regulations will help clarify uncertainties regarding regulatory support of lifetime income options for US retirement plans. Similarly, DCIIA expects that the pace of product innovation and resource development within the retirement income space will increase, helping individuals better manage the spending and distribution phase of their retirement.

Longevity annuities are similar in principle to immediate fixed income annuities, which convert a lump sum into a guaranteed lifetime stream of payments and can only be issued by an insurance company. The primary difference between the two is that longevity annuity payments don't begin immediately, but rather start at some future point.

The value of the longevity annuity is its potential to protect against outliving one's retirement resources. Given the deferred nature of the annuity contract, the size of payments is generally larger relative to the purchase price than that of an immediate fixed income annuity, allowing an individual approaching retirement age to protect against longevity risk while using a portion of his or her assets. An additional benefit is the ability to manage one's remaining accumulated assets to a fixed investment horizon, knowing how much income the contract will provide when one reaches the age selected.

For example, a contract purchased by a 65-year-old might be designed to begin payments at age 85. When the contract holder reaches the age of 85, the payments would commence and be payable for the remainder of his/her life. If the contract holder dies anytime between the purchase date and age 85, no payments are made; however, some products may have a death benefit provision ("return of premium") under which there is a payment equal to the original purchase price.

From a reporting perspective, a QLAC will not be reported as a market value holding as are other qualified investments, and will not be subject to RMD requirements. Prior to the income starting date selected, money invested in or exchanged into a QLAC will not have a market value for plan reporting or RMD purposes and a contract holder will not have the ability to further direct or allocate the amount of funds earmarked for this purpose.

This Frequently Asked Questions (FAQs) resource seeks to provide clarification on common questions that plan sponsors and their advisors may have regarding these new regulations.

1. What is a "qualifying longevity annuity contract (QLAC) as referred to in the regulations?"

A qualifying longevity annuity contract (QLAC) is a deferred income annuity (a contract offered by an insurance company that pays a monthly lifetime income starting at an advanced age, such as 80 or 85) that is designated as a QLAC at purchase and meets the criteria outlined in the regulations. Generally, a QLAC must comply with requirements concerning:

- Limitations on premiums
- Maximum age at commencement
- Form of benefits paid after the death of the employee
- Exclusion of a variable or equity indexed component to the contract
- Exclusion of any commutation benefit, cash surrender value, or similar feature
- Initial disclosures and annual reporting requirements

Some of these requirements are addressed in more detail below.

2. How are these final QLAC regulations different from the earlier proposed QLAC regulations?

They increase the maximum permitted investment

Under the final regulations, the initial dollar limit of the exclusion from required minimum distribution (RMD) rules is \$125,000 rather than \$100,000. Additionally, the dollar limit will be adjusted for cost-of-living increases more frequently, but by a lower amount, in \$10,000 increments instead of \$25,000 increments.

They allow “return of premium” death benefit

Under the final regulations, a longevity annuity in a plan or IRA may provide that, if a purchasing contract holder dies before (or after) the annuity starting date, the premiums paid but not yet received as annuity payments will be returned to the beneficiary. This provision is discussed in more detail in [Question 6](#).

They protect individuals against accidental payment of longevity annuity premiums exceeding the limits

The final regulations permit individuals who inadvertently exceed the 25-percent or \$125,000 limits on premium payments to correct the excess without disqualifying the annuity purchase.

They provide more flexibility in issuing longevity annuities

The proposed regulations provided that a contract is not a qualifying longevity annuity contract unless it states, when issued, that it is intended to be one. In response to comments, the final regulations facilitate the issuance of longevity annuities by allowing the alternatives of including such a statement in an insurance certificate, rider, or endorsement relating to a contract.

3. When are the regulations effective?

Do they apply to existing annuity contracts?

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

An annuity contract in existence before July 2, 2014 will not be considered a QLAC. In order to be considered a QLAC, an existing contract could be exchanged for a new contract that is considered a QLAC. In this situation, the date of exchange will be considered the purchase date and the fair market value on the exchange date will be treated as the premium for purposes of monitoring the QLAC limits.

4. What defined contribution plan types are allowed to offer a QLAC?

The following tax-qualified defined contribution (DC) plan types are allowed to offer a QLAC:

- 401(a), which encompasses 401(k)
- 403(b)
- Eligible governmental 457(b)
- Individual retirement annuities and accounts (IRAs)

5. What is the impact of “required minimum distribution” rules on QLAC purchases under these regulations?

The value of the QLAC will be excluded from the account balance used to determine required minimum distributions. A participant in a 401(k) or similar plan, or IRA, may use the lesser of 25 percent of his/her account balance or \$125,000 to purchase a qualifying longevity annuity. The dollar limit includes all premiums made under any other retirement plan, annuity or account purchased by the individual that was intended to be a QLAC.

6. What is a “return of premium” death benefit and why is it important that this regulation addressed it?

The regulations include a return of premium provision, which guarantees that, upon the contract holder’s death, the beneficiary receives any excess of premiums paid over annuity payments received. The return of premium feature is not a required feature of the QLAC. Additionally, although the return of premium feature reduces the value of the upfront benefit paid to a contract holder, the offsetting cost was deemed to be small. For some participants, the comfort of this feature makes them more comfortable with their insurance purchase decision.

7. What distributions can be made upon an annuitant’s death (other than a return of premium)?

If the Sole Beneficiary is the Annuitant’s Surviving Spouse —

Other than a lump-sum return of premium death benefit, a life annuity is the only benefit available to a surviving spouse.

If the annuitant dies *after* payments under the QLAC begin, the payment to the spouse may not exceed 100 percent of the amount payable to the annuitant.

If the annuitant dies *before* payments under the QLAC begin, the payment to the spouse may not exceed 100 percent of the amount payable to the annuitant, unless

a higher payment is needed to satisfy a requirement under a qualified plan to provide a qualified preretirement survivor annuity.

If the Sole Beneficiary is not the Annuitant's Surviving Spouse. Other than a lump-sum return of premium death benefit, a life annuity is the only benefit available to a non-spouse beneficiary.

If the annuitant dies *after* payments under the QLAC begin, the annuity payment to the beneficiary is determined by reference to a table in Treasury regulations that takes into account the difference in age between the annuitant and the beneficiary.

If the annuitant dies *before* payments under the QLAC begin, the annuity payment to the beneficiary is determined by reference to tables in Treasury regulations, which provide for significantly lower annuity payments if the beneficiary is entitled to a death benefit.

8. Do contract holders have to wait until age 85 before payments from the QLAC can begin?

No. For a contract to be qualified, one requirement is that distributions commence *no later than* the first day of the month following the contract holder's 85th birthday. Payments could begin before this date if:

- The contract specifies an earlier commencement date (e.g., age 80); or
- The contract allows the contract holder to start receiving payments before the specified annuity starting date. The ability to commence early is allowed, but not required, in the QLAC regulations.

Over time, the requirement to begin by age 85 may be adjusted to reflect changes in mortality experience. The regulations anticipate that any changes will happen no more frequently than changes in the dollar limit on aggregate QLAC premiums.

9. Can the QLAC payments, once they begin, increase in the future?

Yes. Pre-existing regulations¹ set out that payments may be increased (or accelerated forward) if certain requirements are met. While a full explanation of these rules is beyond the scope of this FAQ, the regulations permit several types of payment structures, including increases in line with a cost-of-living index, a constant percentage increase, and the ability to accelerate payments forward.

10. Is there a limit to the amount that may be paid as QLAC premiums within a 401(k) or similar plan or IRA and still meet the requirements of these regulations?

The regulations limit the amount that may be paid as QLAC premiums to the lesser of \$125,000 or 25 percent of the individual's account balance at the time of purchase. The dollar limit under the regulations applies in the aggregate to all QLACs purchased for an individual under any IRA or any individual account qualified plan. Therefore, the individual will need to keep track of all of his or her QLAC purchases, whether made through their workplace plan, through an IRA account, or both.

The percentage limit for individual account plans (including qualified plans, 403(b) programs, and governmental 457(b) plans) is calculated based on the participant's account balance as of the last valuation date. The regulations confirm that the plan balance also includes the value of any QLACs held by the plan for purposes of the 25-percent calculation.

The percentage limit for IRAs is calculated based on the IRA account balance as of the preceding December 31st. The QLAC premium would thus automatically be included in the 25-percent-limit calculation for the year of purchase, because the calculation is based on the balance in the purchasing account at the end of the preceding calendar year. The regulations confirm that the QLAC value will be included in the IRA account balance for purposes of the 25-percent-limit calculation for succeeding years as well.

Further details regarding the calculation of the percentage limit are discussed below.

Calculation of 25-percent limit

In contrast to the dollar limit, the 25-percent limit would apply separately to each plan account maintained for a participant. The regulations state that unless the plan administrator "has actual knowledge to the contrary", the administrator may rely on the individual's representations of the amount of QLAC premiums already paid from retirement accounts other than the plan or plans maintained by the same or affiliated employers (controlled groups).

Considerations for IRAs

On the other hand, the account balances in all the IRAs maintained for an individual account holder (except Roth IRA balances) would be aggregated to determine the 25-percent limit on QLAC purchases under IRAs for that individual. Adopting the same approach used under the required minimum distribution (RMD) rules for required

distributions, the regulations provide that the payment of a QLAC premium under one IRA may rely on the other IRA balances to satisfy the 25-percent limit.

The regulations state that unless the IRA custodian, trustee, or insurer “has actual knowledge to the contrary”, the custodian, trustee or insurer may rely on the IRA owner’s representations of the amount of QLAC premiums and account balances already paid from his or her other retirement accounts.

11. What happens if a contract holder accidentally exceeds this limit?

The regulations provide a correction process for a contribution to a QLAC that exceeds the dollar or percentage limit. The process requires the return of the excess amount to the contract holder’s account (or the issuance of a non-QLAC annuity for the excess amount, if the insurer is willing to do so) by the end of the following calendar year.

This correction process is only available to address the payment of QLAC premiums in excess of the limits set forth in the regulations. The regulations state that disqualification of the QLAC due to other defects would be immediate.

12. Will the dollar limit increase over time and, if so, how?

The regulations’ procedure for cost-of-living adjustments to the \$125,000 limit generally corresponds to the adjustment mechanism in the Code Section 415 regulations. The dollar limit will be increased as warranted in \$10,000 increments. The regulations state that the age-85 limit for the commencement of payments may also be adjusted in the future, based on changes in mortality experience. The regulations’ preamble states that it is not anticipated that such adjustments would occur more rapidly than increases in the dollar limit, but there is no further detail on how such an age adjustment would be determined.

13. What happens if, at the time of the QLAC purchase, it represents 25 percent of an individual’s balance (and is less than \$125,000) but, at a later date, due to negative market returns on the non-QLAC account balance, it exceeds 25 percent of his or her total balance?

A QLAC is in compliance if, *at the time of the purchase*, the QLAC premium (plus the value of any prior QLACs that have been purchased) represents 25 percent or less of an individual’s balance. If the non-QLAC account balance

falls due to negative market returns and the value of the original QLAC now exceeds 25 percent of the total balance, then the QLAC is still deemed compliant. The 25-percent test only applies at time of original purchase and /or to a subsequent purchase of another separate and distinct QLAC purchase.

14. What is the impact of a Roth IRA on the amount an individual can place in a QLAC?

None. Roth IRAs are not subject to the minimum distribution rules in Section 401(a)(9) of the Internal Revenue Code, and an annuity purchased under a Roth IRA is not treated as a QLAC. Therefore, the dollar and percentage limitations on premiums that apply to a QLAC do not take into account premiums paid for a contract held under a Roth IRA, even if the contract would otherwise satisfy the requirements to be a QLAC. If a QLAC is purchased or held under a plan, annuity, account or traditional IRA, and that contract is later rolled over or converted to a Roth IRA, the contract is not treated as a QLAC after the date of the rollover or conversion.

15. Are there any reporting requirements for a plan sponsor or plan provider with regard to the QLAC?

No. While there are annual reporting requirements, it is the responsibility of the insurer to comply with the reporting requirements. Details of the reporting requirements are described in our response to [Question 18](#).

16. Are these regulations a “safe harbor” for plan sponsors with regard to offering annuity products in their retirement plans?

No. This is a tax regulation and, as such, does not address the fiduciary requirements governing qualified plans operating under the Employee Retirement Income Security Act of 1974 (ERISA). However, the US Department of Labor (DOL) oversees ERISA matters and has announced a project to update the current regulations concerning annuity carrier (i.e., insurer) selection in this area early in 2015. The carrier selection safe harbor regulation is expected to apply to carrier selection generally, and is expected to include QLAC provider selection. As always, it is important to keep in mind that while a safe harbor is very helpful to plan sponsors, a safe harbor presents one way, but not the only way, to meet fiduciary requirements.

17. These final regulations address QLACs, but do they have any impact on other annuities offered in-plan or in other retirement accounts, such as fixed annuities or variable annuities with guaranteed minimum withdrawal benefit (GMWB) riders?

No. The final regulations provide an exception to the otherwise applicable Required Minimum Distribution rules with respect to QLACs. Annuity contracts that do not meet the requirements of a QLAC will continue to be treated as any other plan holding for purposes of applying the RMD rules. The regulations at present are limited to fixed income annuity contracts only, and would not permit any form of variable or equity-indexed annuity product to qualify as a QLAC.

18. How would one know if the annuity offered in his or her retirement plan or IRA is a QLAC?

The final regulations contain reporting requirements that clarify whether an annuity is a QLAC or not.

Upon issuance of an annuity contract, the insurer must notify the contract holder that the contract is intended to be a QLAC. This allows all interested parties – the contract holder, the plan sponsor (if purchased through a qualified plan distribution option) or IRA provider and the IRS – to be aware that the QLAC regulations apply to a given contract. The notice may be included directly in the contract or in a rider or endorsement pertaining to said contract.

Annually thereafter, the insurer must provide reports to both the contract holder and the IRS. The annual reports help the plan sponsor and participant to comply with the QLAC regulations and enable the IRS to properly enforce them. Details that must be included in the reporting include, but are not limited to, contact information for the insurer, the identities of the contract holder and plan sponsor (if applicable), the annuity commencement date, premiums paid, and the year-end contract value of the QLAC.

As with the regulations concerning qualified default investment alternatives (QDIAs), there will not be an “approved list” of QLACs. Plan sponsors must still perform due diligence to determine whether a given annuity is designed to comply with the QLAC regulations.

19. Are there any conflicts between these Treasury regulations and Department of Labor rules?

No, there are no conflicts between these Treasury regulations and any existing Department of Labor (DOL) guidelines surrounding annuity selection within participant-directed qualified plans. These regulations specifically address the required minimum distribution (RMD) rules regarding plan withdrawals, not annuity selection by plan sponsors. Under existing DOL rules, a plan sponsor is required to go through a prudent process in selecting a QLAC, similar to the prudent process for any investment selection in a plan.

20. Do these regulations apply to defined benefit (DB) plans?

They do not. Treasury noted that commentators on its proposed regulations had recommended that Treasury consider extending the QLAC regulations to DB plans. The final regulations note that,

“Defined benefit plans generally are required to offer annuities, which provide longevity protection. Because longevity protection is already available in these plans, the final regulations do not apply to defined benefit plans. However, Treasury and the IRS request comments regarding the desirability of making a form of benefit that replicates the QLAC structure available in defined benefit plans. In particular, Treasury and the IRS request comments regarding 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.”²⁹

This is consistent with the discussion at the 2012 Public Hearings, during which Treasury officials indicated they had not considered the need for QLAC applicability to DB plans.

SUMMARY

DCIIA expects these new regulations, in conjunction with other recent policy changes, such as Revenue Ruling 2014-9 on plan-to-plan rollovers, and other items on the regulatory agenda, including the lifetime income benefit statement project and the revisit of the annuity selection safe harbor language, to support the transformation of participant-directed savings plans into plans structured for both the accumulation and decumulation of assets. Further, we view these enhancements as support for the qualified plans arena and hope that the pace of product innovation and resource development within the retirement income category will increase, helping individuals better manage the spending and distribution phase of their retirement.

ENDNOTES

¹ 401(a)(9)—6 Required minimum distributions for defined benefit plans and annuity contracts.

² Department of The Treasury. Internal Revenue Service. 26 CFR Parts 1 and 602. RIN 1453-BK23. Longevity Annuity Contracts. Section V. Defined Benefit Plans. Retrieved from <http://www.regulations.gov/#!documentDetail;D=IRS-2012-0005-0050>.

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

For more information, visit: www.dciia.org.