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IRS issues final regulations on longevity annuities in individual account plans

Effective July 2, 2014, deferred annuities that meet the criteria for a qualifying longevity annuity contract can be excluded from participant account balances when calculating required minimum distributions. This will allow retirees to purchase a deferred annuity to provide an income stream starting at an advanced age without concerns over cash flow to meet the minimum distribution requirements. The annuity premium cannot be more than the lesser of $125,000 or 25% of the account balance and annuity distributions must start no later than age 85. Special rules apply to death benefits and reporting requirements.

In this article: Background | Requirements for treatment as a QLAC | One $125,000 limit per person | Permissible options for distributions after death | Distribution decisions – a real-life example | Reporting and disclosure requirements | In closing

Background

One of the tax requirements for traditional tax-favored retirement plan accounts is that account holders must meet minimum distribution requirements beginning no later than April 1 following the year the participant attains age 70½. Participants in plans other than IRAs who are not 5% owners can delay distributions while they are still actively employed. The required minimum distributions are intended to prevent individuals from deferring payment indefinitely. While the required minimums are set using a table of life expectancy factors, there is no guarantee that payments will continue for life. Most defined contribution plans provide lump sum or installment forms of distributions but due to the increasing life expectancy trends, there is valid concern that some participants will outlive their savings. As a result, there has been a push to add annuities as a distribution option. In light of the reluctance of most individuals to turn their accumulated retirement funds over to an insurer at the beginning of their retirement years, some experts had suggested that a middle ground might be to dedicate a small portion of savings to cover the risk for the years beyond average life expectancy. But the ability to include a deferred annuity starting after age 70½ in these arrangements was complicated by the need to take minimum distributions on assets including the value of the premium to purchase the deferred annuity. If the deferred annuity did not have a cash surrender value that

could be accessed to meet the required minimum, a participant would face penalties for failing to meet the requirement after the other account assets were depleted.

On February 2, 2012, IRS proposed regulatory changes that would accommodate the purchase of certain longevity annuity contracts by excluding contract values from the required minimum distribution (RMD) calculations. The proposal would have accommodated deferred annuities with limited death benefits purchased with up to 25% of an individual's account balance to a maximum of $100,000.

Requirements for treatment as a QLAC

The July 2, 2014 final regulations permit individuals in a defined contribution plan qualified under section 401(a), a 403(b) plan, a governmental 457(b) plan, or a traditional IRA to exclude amounts invested in a qualifying longevity annuity contract (QLAC) from the calculation of the RMD. The exclusion is not available in a defined benefit plan nor is an employer permitted to offer the purchase of the defined contribution plan's QLAC from the employer's defined benefit plan. To be considered qualified, the annuity must meet the following criteria:

- The QLAC must be purchased from an insurance company.
- Payments must begin no later than the first day of the month following the employee's 85th birthday. The age 85 requirement may be adjusted in future years for changes in mortality rates.
- The premiums cannot exceed the lesser of 25% of the employee's account balance on the date of payment, or $125,000.
- The contract cannot contain any features that would provide for commuted benefits (lump sum distribution) or cash surrender rights.
- The contract (or rider or certificate) must state that it is intended to be a QLAC.
- Death benefits must meet very specific requirements depending on various factors, such as whether the beneficiary is a spouse, when the participant dies, and whether there are multiple beneficiaries.
- The annuity cannot be a variable annuity, but it can be a participating annuity that pays dividends, and it can be an increasing annuity that provides for cost-of-living increases.

Buck comment. Employers concerned about employees outliving their retirement savings, but reluctant to undertake the responsibility of selecting annuity products to offer through the plan, may want to consider adding a post-termination partial withdrawal feature to their plans. This will encourage participants to keep money in the plan while at the same time providing access to funds in retirement and accommodating the purchase of a QLAC outside the plan through an IRA.

One $125,000 limit per person

The dollar limit of $125,000 applies to all accounts held by the participant — retirement plans and IRAs combined. The 25% limit applies individually by plan but on a combined basis for IRAs. That is, the individual determines the QLAC maximum for IRA accounts using the sum of account balances and can purchase the QLAC in total from any of the individual accounts. The 25% limit is based on the value of the account as of the last valuation (increased for contributions and decreased for distributions) prior to the annuitization. Because Roth IRAs are not subject to the RMD rules, any balances annuitized from a Roth IRA will not count toward the limits.

> Buck comment. Because Roth IRAs are not subject to the RMD rules, funds in those accounts can be used to purchase longevity annuities without any restrictions on amount or annuity features. However, individuals may be hesitant to use Roth funds on which taxes have already been paid rather than using funds on which taxes may never be paid in the event of early death.

If the annuity exceeds the limit, the entire QLAC is deemed nonqualified, not just the portion representing the excess. However, the QLAC will remain qualified if the excess is returned to the non-QLAC portion of the employee's account no later than the end of the calendar year after the premium is paid.

Permissible options for distributions after participant's death

The final regulations aim to maximize the lifetime benefit available to the individual by limiting the extraneous features that would add to cost. However, some limited death benefits are permitted. Death benefit distribution options available to the beneficiary from a QLAC are dependent upon whether the spouse is the sole beneficiary and whether the participant died before or after annuity payments started.

Return of premium

In response to concerns that a participant might not want to purchase an extremely deferred annuity for fear of dying before receiving the full value of the policy, the final regulations permit a QLAC to provide a return of premium (ROP) provision. The ROP is the excess of the premium over the payments made to the employee under the QLAC. For QLACs that provide a life annuity for the surviving spouse, a ROP is permitted to be provided for a subsequent beneficiary. The ROP must be paid no later than the calendar year following the calendar year of the participant or surviving spouse's death. If the ROP is made after the participant or surviving spouse has attained age 70½, the distribution is considered a required minimum and is not eligible for rollover.

Spouse as sole beneficiary

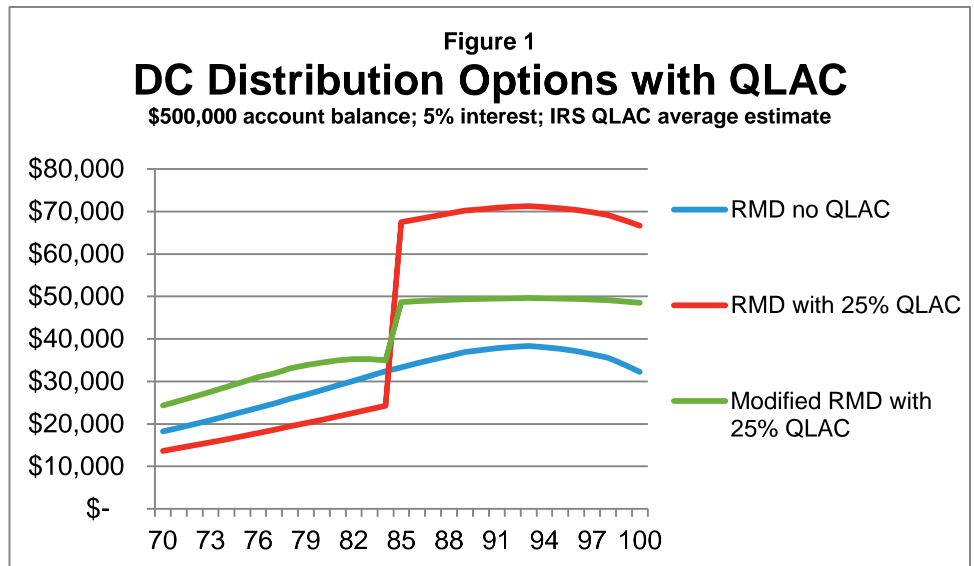
If the participant dies after the annuity starting date, the only option to the spouse is a life annuity not to exceed 100% of the payment that the participant was receiving in his or her lifetime. If the participant dies before the annuity starting date, the same option is available except the payment may be increased to satisfy the requirement to provide a qualified preretirement survivor annuity. Any life annuity to the surviving spouse must start no later than the date the annuity would have been payable to the participant had he or she lived.

Non-spousal beneficiary or multiple beneficiaries

Generally, if the spouse is not the sole beneficiary of the contract, then absent a ROP, the only permitted benefit is a life annuity payable to the designated beneficiary. Lifetime benefits for non-spouse beneficiaries are limited based on the age difference between the account holder and the beneficiary. For a QLAC that does not provide such a death benefit before the QLAC begins, the new regulation limits the survivor annuity percentage using the existing table in the RMD regulations for joint and survivor distribution options. For example, an individual at age 70 with a non-spouse beneficiary who is 25 years younger is limited to a survivor percentage of 66%. A more restrictive table is added for the situation where the QLAC provides life annuity death benefits prior to the QLAC's annuity starting date. Under that table, the same individual with a nonspouse beneficiary who is 25 years younger is limited to a survivor percentage of 20%. For QLACs with pre-commencement death benefits, the non-spouse beneficiary must be irrevocably selected by the later of the annuity purchase date or the required beginning date.

Distribution decisions – a real-life example

Only a portion of a participant's account may be used to purchase a QLAC. These two charts provide three scenarios to illustrate how a participant might structure the draw-down on the balances not dedicated to the QLAC and the impact on the death benefit (funds) remaining for her beneficiary. Assuming a participant uses the RMD life expectancy tables to determine her annual income stream, Figure 1 provides an example of three withdrawal alternatives:



- RMD with no QLAC
- RMD with 25% QLAC
- A modified RMD with 25% QLAC

The blue line illustrates the RMD using joint life factors with no QLAC. This line is used for a baseline to compare how a QLAC can impact income streams in retirement. The red line applies the RMD uniform life factors to the balance of the account after buying the QLAC and adds the QLAC payments at age 85. This option may be appealing for addressing the possibility of increased costs to pay for assisted living housing at an advanced age. The green line uses the RMD factors adjusted by a factor of 12 so that higher annual distributions are made before the QLAC payments start. This option tends to smooth the distributions so that the individual has more income for their earlier retirement years. Also, by adjusting the factors, the annual distribution amount yields more annual income when compared to the "RMD no QLAC" blue line.

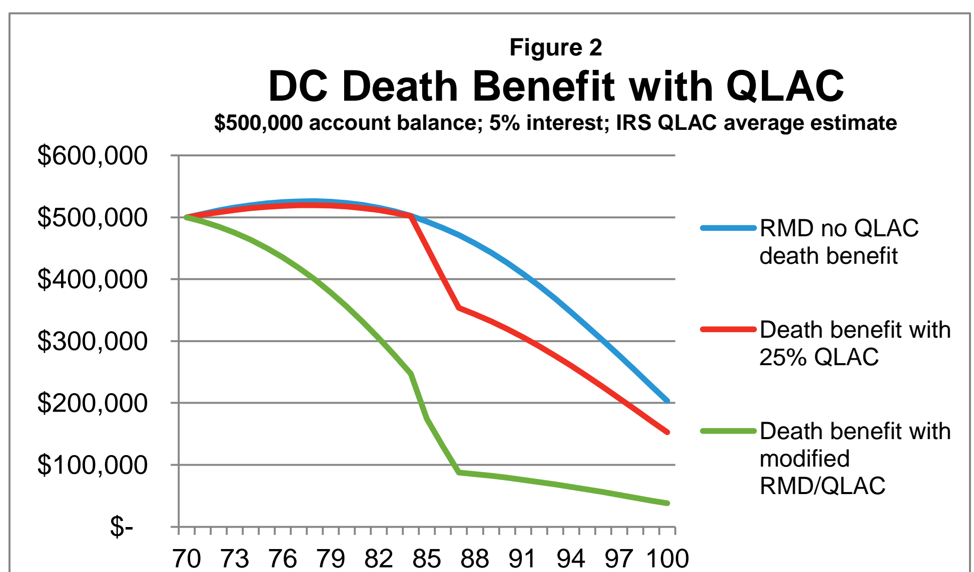


Figure 2 shows the impact to the death benefit for heirs under the three scenarios in Figure 1. The blue line, "RMD no QLAC death benefit," illustrates the balance remaining each year as a death

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benefit to an individual's heirs. Again the blue line will be used as the baseline. Since the red line applies the same RMD factors as the baseline, the red line illustrates the impact to the death benefit (which includes a ROP) when the QLAC kicks in. The green line illustrates the impact on the death benefit (which also includes a ROP) when applying the adjustment of 12 to the RMD factors. As illustrated in Figure 1, due to the higher annual distribution amounts in earlier years, the death benefit is substantially reduced.

Reporting and disclosure requirements

The insurance company that issues the QLAC must file annual calendar year end reports and provide statements to account holders about the status of their contracts. The required information includes:

- The issuer's name, address, identifying number, and contact information
- Name, address, and identifying number of the annuitant
- Plan name, number, and Employer Identification Number, if purchased under a plan
- Annuity starting date, if payments have not commenced
- Amount and date of premiums paid in total and for prior year
- Fair market value of the QLAC

Unlike the proposed regulations, the final regulations do not require that an initial disclosure be provided prior to obtaining the QLAC. Rather, the plan or IRA may rely on existing disclosure practices under state law. The annual disclosure will be similar to the Form 5498, and the IRS is expected to issue a new form for this purpose.

In closing

The regulations apply to contracts purchased or exchanged on or after July 2, 2014. The introduction of the QLAC may provide an appealing option for individuals to address the fear of outliving assets. However, there is no requirement to offer a QLAC in employer-sponsored retirement plans. Employers will need to weigh the merits of adding the product to meet employee needs against fiduciary considerations, such as vendor selection for the annuity, when deciding whether to offer QLACs.

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Authors
Lisa A. Scalia, CPC, QPFC, QPA, QKA
Joanne Jacobson, JD, LLM
Marjorie Martin, EA, MAAA, MSPA

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