September 2014

PENSION ANALYST

Important information—Plan design

IRS provides guidance on Qualified Longevity Annuity Contracts

Who's affected

These regulations apply to 401(a)-qualified defined contribution plans, 403(b) plans, IRAs and governmental section 457(b) plans. They apply to contracts purchased on and after July 2, 2014.

Background and summary

In 2012, the IRS published several pieces of guidance to encourage defined contribution plan sponsors to offer lifetime income options. That package of guidance included two proposed regulations and two Revenue Rulings. One of the proposed regulations created the concept of qualified longevity annuity contracts (QLACs), as an exception to the Required Minimum Distribution (RMD) rules, to allow retirement plan participants to purchase annuities that begin making payments at an advanced age.

On July 2, 2014, the IRS published final QLAC regulations reflecting the issues raised and suggestions made by the individuals and organizations that submitted comments on the proposed regulations. Under these final rules:

- The premium to purchase the QLAC cannot exceed specified dollar and percentage limits.
- The contract, or related certificate issued to the employee, must state that it is intended to be a QLAC.
- The contract cannot be a variable contract, an indexed contract, or similar contract.
- Distributions must begin no later than the first day of the first month after the employee reaches age 85.
- Payments must meet the RMD calculation requirements.
- The contract cannot provide any commutation benefit or cash surrender value.
- The only death benefits provided are life annuities to designated beneficiaries (subject to certain requirements) or a return of premium (ROP) payment.
- Both plan sponsors and participants are subject to additional reporting requirements.

Plans are not required to offer QLACs. However, plan sponsors that wish to do so must ensure that all of these requirements are satisfied. Otherwise, the failure to begin payments from the contracts will violate the RMD rules and will subject the recipient to federal excise taxes.

Action and next steps

Plan sponsors that are interested in providing this new lifetime income option to participants in their defined contribution plans should read this publication carefully. Before implementing any changes to their plans, they should carefully explore their options with their document providers and recordkeepers, including Prudential Retirement. As an alternative, they may want to consider other solutions designed to provide guaranteed income or the options made available under IRS Revenue Rulings 2012-3 and 2012-4.

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What are longevity annuities?

A longevity annuity is a deferred annuity that begins making payments at an advanced age, such as 80 or 85. These deferred income annuities are designed to provide peace of mind, as well as income, to owners who are concerned that they might outlive their more traditional investments. In addition to providing income at such advanced ages, they are typically less expensive to purchase precisely because payments begin so late.

Are longevity annuities currently offered under employer-sponsored retirement plans?

Despite their attractive features, it has not been practical to offer longevity annuities under qualified retirement plans or traditional IRAs, due to the application of the RMD rules (the RMD rules do not apply to Roth IRAs). These rules require the participant or IRA holder to include the value of the annuity contract in his account balance when calculating the annual RMD until he starts receiving payments from the annuity. This increases the amount of RMD that must be paid. As a result, the individual runs the risk of depleting his other account assets before the longevity annuity's starting date, causing the individual to violate the minimum distribution requirements and incur a 50% excise tax.

How do the QLAC regulations address these issues?

The QLAC regulations provide an exception to the RMD rules for longevity annuity contracts purchased on or after July 2, 2014, which meet certain requirements:

- The premium to purchase the QLAC does not exceed specified limits.
- The contract, or related certificate issued to the employee, states that it is intended to be a QLAC.
- The contract is not a variable contract, an indexed contract, or similar contract.
- Distributions begin no later than the first day of the first month after the employee reaches age 85.
- Payments meet the RMD calculation requirements.
- The contract does not provide any commutation benefit or cash surrender value.
- The only death benefits provided are life annuities to designated beneficiaries (subject to certain requirements) or a return of premium (ROP) payment.
- Both plan sponsors and participants are subject to additional reporting requirements.

Premium limits

The amount of premiums paid to purchase longevity annuities cannot exceed the lesser of:

- $125,000 (subject to annual cost-of-living adjustments), or
- 25% of the participant's account balance on the date of the premium payment.

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The $125,000 limit is an aggregate limit, taking into account all of the participant's retirement plan account balances and non-Roth IRAs. It will be adjusted in $10,000 increments.

The 25% limit applies on a plan-by-plan basis. However, if a QLAC is purchased for an IRA, all IRA balances must be aggregated.

If the premium limits are accidentally exceeded, the error may be corrected and the QLAC status maintained if the excess premium is returned to the non-QLAC portion of the participant's account by December 31 of the calendar year following the calendar year in which the premium was paid. The excess premium may be returned in cash or in the form of a non-QLAC annuity. If the excess is returned after the final valuation date of the plan year in which it was paid, the participant's account balance must be recalculated taking into account the excess premium for purposes of determining the individual's RMD.

Death benefits

The only death benefits that may be provided under a QLAC are life annuities to designated beneficiaries (subject to certain requirements) or a return of premium (ROP) payment.

Life annuities

If the participant's sole beneficiary is his surviving spouse, the life annuity payable to the spouse cannot exceed 100% of the annuity that was payable to the participant. If the participant dies before his annuity starting date, payments to the surviving spouse must begin no later than the date they would have begun if the participant had not died.

If the participant's sole beneficiary is not his surviving spouse, the life annuity payable to the beneficiary cannot exceed the "applicable percentage" of the annuity that was payable to the participant. The applicable percentage is determined under one of two alternative tables provided in the regulations, which apply based on the types of death benefits payable to the beneficiary. If a ROP payment is provided, no annuity is payable.

Return of premium payment

A ROP provision pays a single sum death benefit that is equal to the amount of premium payments made by the participant, less the amount of annuity payments made to the participant under the QLAC. The ROP benefit may be payable both before and after the participant's annuity starting date. In addition, an ROP payment may be provided after the death of both the participant and his surviving spouse.

The ROP payment must be paid no later than December 31 of the calendar year following the calendar year in which the participant (or spouse, if applicable) dies. If the participant dies after his Required Beginning Date (RBD), the ROP payment is treated as an RMD for the year in which it is paid and is not eligible for rollover. Likewise, if the surviving spouse dies after her RBD, the ROP payment is treated as an RMD for the year in which it is paid and is not eligible for rollover.

Additional considerations

While these regulations remove one major obstacle to offering longevity annuities under qualified retirement plans and non-Roth IRAs, plan sponsors need to be aware of important additional considerations before they consider adding QLACs as a plan distribution option.

First, plan sponsors need to be aware of their fiduciary responsibilities of prudence and due diligence when choosing among the longevity annuity options offered by insurance companies.

Plan sponsors also need to recognize the potential administrative complexity that could result if they change recordkeepers and the new provider does not offer QLACs. Participants who are already invested in QLACs may be able to retain their

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existing contracts but the plan may then be considered split-funded, with assets held by multiple vendors, which must then be aggregated for Form 5500 reporting purposes.

In addition, the regulations do not address the portability of QLACs in the event a participant who has purchased a QLAC changes employment and is no longer a participant in the plan. It is unclear whether QLACs will be considered eligible for rollover to other employer-sponsored plans or IRAs, or whether plans will be required to accept QLAC rollovers.

Both plan sponsors and participants need to understand that an investment in a QLAC is irrevocable. While death benefits must be provided under these contracts, the contracts are prohibited from providing commutation benefits or cash surrender values. As a result, participants cannot transfer funds in and out of QLACs in the same manner that they can transfer funds among other plan investments.

In recent years, many plan sponsors have taken steps to eliminate annuity options from their 401(k) and profit sharing plans in order to avoid dealing with the Qualified Joint and Survivor Annuity (QJSA) and Qualified Preretirement Annuity (QPSA) notice, waiver and consent requirements. Since a QLAC is an annuity, the QJSA and QPSA rules would apply to participants who purchase them, subject to the special provisions described in IRS Revenue Ruling 2012-3.

Plan sponsors will also need to monitor the premium limits and be prepared to take swift measures to correct any excesses that may occur, in order to avoid plan compliance issues.

Plan sponsor next steps

Plans are not required to offer QLACs. Plan sponsors that are interested in providing lifetime income options to participants in their defined contribution plans may simply want to consider QLACs along with other options that are available. Before making any changes to their plans, they should carefully explore these options with both their document providers and recordkeepers, including Prudential Retirement, to ensure compatibility between plan design and administrative capabilities.

Pension Analyst by Prudential Retirement
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