

# DIAs & QLACs: What the new Treasury regulations mean for advisors

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Find out what the new regulations on the use of deferred income annuities in IRAs and qualified plans will mean for advisors and their clients.

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In February 2012, the IRS proposed regulations on a new type of annuity contract called a **“Qualifying Longevity Annuity Contract”** (QLAC), provoking considerable interest and discussion in the financial services industry. On July 2, 2014, **final regulations were published**, and the discussion continues, often marked by confusion and inaccuracies. Much of this confusion is the result of inconsistent terminology. Here, we aim to set the record straight, and provide some clarity about what all this really means for practitioners and their clients.

## The “longevity annuity”

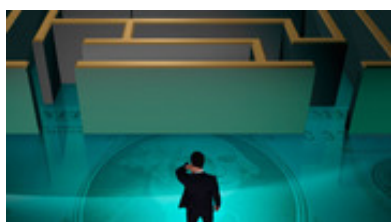
According to Prof. Moshe Milevsky, the concept of an annuity product that could be purchased at an early age, for relatively small premiums paid over many years, and that would only begin paying inflation-adjusted lifetime income benefits at an advanced age

such as 80 or 85, has been around since the late 1970s. In 2004, Milevsky delved further into this idea with a paper introducing a concept product which he called an “Advanced-Life Delayed Annuity” (ALDA).

An ALDA would be a life annuity product (offering only a life contingent payout option and not any type of payout for only a specified period of years) that could be purchased years in advance of the income payments, guaranteeing the dollar value of those income payments, but offering no cash value or death benefit during the period from purchase until the Annuity Starting Date (ASD) -- and often restricting the purchaser’s ability to select only an ASD of age 85 or similar advanced age.

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According to Curtis Cloke, this type of annuity product first became approved to be offered for retail sale in 1979, but due to lack of marketing, it was not actually sold until 1999. It has generally been referred to as a “longevity annuity.”

### The “deferred income annuity”

A more generalized version of the longevity annuity product, typically referred to as a “**deferred income annuity**” or **DIA**, has also been around since 1999. This variant often allows life and joint life-contingent, period certain, installment and cash refund annuity payout options, and may offer commutation or a death benefit payable at the annuitant’s death (before or after ASD).

It must be understood that longevity annuities and deferred income annuities are not two distinctly different types of contract. Each is a Deferred Income Annuity – an annuity contract which may be purchased well in advance of the ASD, where the amount of annuity income is guaranteed at the time of purchase. Some DIAs contain a particular combination of features that conform to Moshe Milevsky’s original “ALDA” concept – that is, no cash value, little or no flexibility as to the ASD, and only life-contingent payout options. These are essentially a sub-type of DIAs, often referred to as “longevity annuities.”

These more flexible contracts are often referred to as “DIAs,” as though they are different from “**longevity annuities.**” But the truth is that all these products are DIAs; some simply offer features and flexibility that others do not. While both longevity annuities and the more generalized and flexible DIA versions are currently offered, contracts of the DIA variety offering a death benefit and more flexibility as to ASD are, according to Curtis Cloke, more popular with consumers.

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However, the new Treasury regulations on QLACs (which offer limited flexibility as to ASD and a “return of premium” death benefit but permit no cash or commutation value) may change this somewhat, as the new QLAC rules are closer to Milevsky’s ALDA-style longevity annuity type of DIA. DIAs represent only about 1 percent of current annuity sales, but their numbers are increasing and the new QLAC regulations may increase this trend.

One reason for the increasing popularity of all DIAs is increased consumer concern for income guarantees that will last a lifetime. Of course, other types of annuities can provide this benefit, but DIAs may offer greater financial leverage -- the ratio of guaranteed benefits to premium cost, impacted by how annuitant mortality is utilized (mortality credits).

### **How and why the regulations were issued**

All DIAs work fine in non-tax deferred accounts (accounts other than IRAs or qualified plans). But because some DIAs do not have a cash value (or other commutation/liquidity provisions) from which Required Minimum Distributions (RMDs) may be paid, a DIA with an ASD later than age 70½ has presented difficulties. It was this clash of longevity type DIA contract provisions with RMD requirements applying to IRAs and qualified plans that made it necessary for Treasury to provide regulations concerning the use of DIAs in IRAs and qualified plans.

The proposed QLAC regulations published March 26, 2012, offer a valuable insight into how and why these regulations came into being. The “Background” section states the following:

“On February 2, 2010, the Department of Labor, the IRS and the Department of the Treasury issued a 'Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans.' That Request included questions relating to how the required minimum distribution rules affect defined contribution plan sponsors’ and participants’ interest in the offering and use of lifetime income. In particular, the Request for Information asks whether there were changes to the rules that could or should be considered to encourage arrangements under which participants can purchase deferred annuities that began at an advanced age (sometimes referred to as **longevity annuities** or longevity insurance).”



A number of commentators identified the required minimum distribution rules as an impediment to the utilization of these types of **annuities**. One such impediment that they noted is the requirement that, prior to annuitization, the value of the annuity be included in the account balance that is used to determine required minimum distributions. This requirement raises the risk that, if the remainder of the account has been depleted, the participant would have to commence distributions from the annuity earlier than anticipated in order to satisfy the required minimum distribution rules. Some commentators stated that if the deferred annuity permits a participant to accelerate the commencement of benefits, then, in order to take that contingency into account, the premium would be higher for a given level of annuity income regardless of whether the participant actually commences benefits at an earlier date. Some commentators also noted that longevity annuities often do not provide a commutation benefit, cash surrender value, or other similar feature.” (From Internal Revenue Bulletin 2012-13.)

What was to be done with DIAs having an ASD later than age  $70\frac{1}{2}$  (and no commutation or other liquidity feature)? According to Curtis Cloke, some DIA issuers accommodated IRA-held DIAs with ASD's after age  $70\frac{1}{2}$  by utilizing the 12/31/prior year Actuarial Present Value annually reported to the IRS. These carriers believe, he says, that this meets a sufficient de facto cash balance reporting necessary to incorporate DIAs with other cash value assets to determine overall client RMD requirements.

Cloke reports that issuers of DIA contracts for products filed and approved just prior to 2006 suddenly began annual filings of Form 5498 when those contracts were held in tax-

deferred accounts but that issuers of contracts for products filed well before 2006 did not do so, even for contracts held in such accounts. Prior to 2006, Cloke states that he had not seen such filings for DIAs. Why this change? Michael Kitces notes that new valuation and reporting rules for deferred annuities for RMD purposes were introduced in 2004 as part of an updated Treasury regulation (from Treasury Regulation 1.401(a)(9)-6, Q&A-12), with reporting that began in subsequent years.

Non-annuitized DIAs are indisputably deferred annuities, and it seemed obvious that these contracts, when held in tax-deferred accounts, would be subject to RMD rules. But what if they had no cash value? Insurers could report the Actuarial Present Value, but contract owners would still be responsible for paying RMDs attributable to that value. But what if they have liquidity (e.g., commutation or a cash value) to satisfy the RMD? If the taxpayer has other Traditional IRAs, the DIA-attributable RMD can be taken from another IRA. Cloke states that he recently sold a DIA with an ASD of age 78 to a 73-year-old purchaser's Traditional IRA. That purchaser was required by the insurer to sign a disclosure statement confirming that he had sufficient other Traditional IRA assets to meet his Traditional IRA RMDs for the five-year deferral period.

But what if there are no other IRAs? Cloke reports that, when such a traditional IRA-held DIA is the only IRA asset of a contract owner, some insurers permit him or her to withdraw an amount equal to that RMD (based upon that Actuarial Present Value) after age 70½ but before Annuity Starting Date. Of course, such a withdrawal would result in an adjusted annuity benefit as of ASD, and such a liquidity provision might (adversely) impact the pricing of the DIA in the first place.

Thus, some investors may prefer to allocate IRA dollars to a DIA that does not allow any liquidity before the ASD (to improve the pricing of the DIA benefits in the future), but that still puts those investors in a position of risk if other IRAs might be depleted, such that they will now be unable to satisfy their RMD obligation at all. In other words, as Michael Kitces puts it, "What if I do not want to risk having insufficient IRA assets outside the DIA and I want in my IRA a DIA that doesn't have a commutation/liquidity provision?" The final QLAC regulations solve that problem.



### What the regulations say:

An excellent synopsis of the Final **QLAC** Regulations was provided shortly after release of those regulations by Michael Kitces, in his popular online blog, Nerd's Eye View, as follows:

To be eligible as a QLAC, a longevity annuity must meet the following requirements:

- Only 25 percent of any employment retirement plan (or 25 percent across all pre-tax IRAs aggregated together) can be invested into a QLAC.
- The cumulative dollar amount invested into all QLACs across all retirement accounts may not exceed the lesser of \$125,000 (original regulations were only \$100,000), or the aforementioned 25 percent threshold. The \$125,000 dollar amount will be indexed for inflation, adjusted in \$10,000 increments.
- The limitations will apply separately for each spouse with their own retirement accounts.
- The QLAC must begin its payouts by age 85 (or earlier).
- The QLAC must provide fixed payouts (not variable or equity-indexed), though it may have a cost-of-living adjustment (COLA).
- The QLAC cannot have a cash surrender value once purchased (i.e., it must be irrevocable and illiquid), but it can have a return-of-premium death benefit payable to heirs as a lump sum or a stream of income.

If the longevity annuity meets the above requirements to be deemed a QLAC, then the value of the QLAC is excluded when calculating RMDs (for other retirement assets), and the payments from the QLAC (whenever they begin) are implicitly assumed to satisfy their RMD obligation (though the QLAC payments will not satisfy RMDs for any other retirement accounts).

**Example:** Jeremy purchased a \$50,000 QLAC at age 65 that will begin payments of \$15,937/year at age 85. In addition, he has \$400,000 of other IRA assets. By age 70½, his IRA has grown to \$600,000, and he must begin to take RMDs from the account. His RMDs will be calculated only on the \$600,000 account balance, and not include any implied value from the QLAC. Moreover, when Jeremy turns 85 (and we'll assume his IRA is up to \$900,000), he will begin to receive his \$15,937/year payments from the QLAC begin, he will still have to take RMDs from his \$900,000 IRA (and cannot count any of the \$15,937/year QLAC payments towards his IRA's RMD). The \$15,937/year payments from the QLAC itself will automatically (because the QLAC was qualified in the first place) be deemed to meet the RMD rules for that portion of Jeremy's assets.

Notably, longevity annuities purchased in Roth accounts are not considered QLACs, for the simple reason that Roth IRAs do not have RMDs to comply with in the first place; as a result, an unlimited amount of longevity annuities could be purchased within a Roth IRA (if desired), and the account balances and longevity annuities inside Roth IRAs are not counted towards the \$125,000 and 25 percent limits.

For contracts purchased in traditional retirement accounts (IRAs or employer retirement plans), the dollar and percentage limits do apply. In practice, most investors will be limited to 25 percent of retirement accounts, as until they have at least \$500,000 of retirement accounts the 25 percent limit will hold (only with accounts greater than \$500,000 would the \$125,000 dollar limit be the lesser of \$125,000-or-25 percent). On the other hand, each spouse could invest this much into a QLAC, effectively doubling the longevity annuity amount for a couple (if desired).





## **What are practitioners asking?**

### ***1. Can a QLAC in a qualified plan be converted to a Traditional IRA?***

Some qualified plans must offer a qualified pre-retirement survivor annuity (QPSA). A QLAC in such a plan, having such required language, may prove problematic when transferred to an IRA with a non-spouse beneficiary.

### ***2. Can a QLAC in a qualified plan be converted to a ROTH IRA?***

It is not yet clear whether a QLAC in a qualified plan can be converted to any type of IRA. Gary Mettler and Michael Kitces believe that unless it is determined that the rules specifically disallow such conversion, some insurers will permit it. "It's a logical extension. They will just use the same 12/31 valuation statements for RMD purposes or perhaps a specially prepared valuation statement at the time of conversion. They would then issue the appropriate Roth amendments to the contract", says Mettler. That said, the same QPSA requirement for qualified plans as noted above may prove administratively difficult.

### ***3. Can a QLAC in a Traditional IRA be converted to a ROTH IRA?***

The Final Regulations do not prohibit such a conversion, and as long as the contract can be appropriately valued (as it generally already is for RMD purposes) the Roth conversion should be permissible. Technically, the resulting contract will not be a QLAC, but only because it doesn't need to be anyway, as the purpose of QLAC rules is to coordinate between longevity-style DIAs and the RMD rules, which are a moot point for Roth IRAs that



do not have RMDs during the life of the IRA holder.

#### ***4. May an individual purchase a QLAC after Required Beginning Date (RBD)?***

This is answered by implication in the revised Treasury Reg §1.401(a)(9)-6, A-17(c)(v), which states that, for contracts permitting set non-spousal beneficiary designation, “payments are payable to the beneficiary only if the beneficiary was irrevocably designated on or before the later of the date of purchase or the employee’s required beginning date”. Clearly, an employee (in the case of a qualified plan) or IRA participant may purchase a QLAC after RBD.

#### ***5. How must annuity issuers modify the language of existing DIAs to make those contracts QLACs?***

Carriers must disclose that the contract to be considered a QLAC is intended to be a QLAC. And an annual report to include the minimum requirements found in the Initial Disclosure and Annual Reporting Requirements of the Final Regulations. This disclosure can be in the form of a rider or endorsement, certificate and continue annually while the contract is in the deferral period. All RMD MDIB (Minimum Death Incidental Benefit) rules must be followed after the ASD.

#### ***6. May both QLACs and non-QLAC DIAs be held in a taxpayer’s Traditional IRA and will the QLACs get the RMD exemption of the regulations but the non-QLAC DIAs will not?***

The regulations answer this question by their focus; they address QLACs only, not IRA-held DIAs that are not QLACs. They take away nothing that was in existence before. Nothing in the regulations prevents a taxpayer from holding a non-QLAC DIA in a Traditional IRA and the method of RMDs has already been established for non-QLAC DIAs. The Actuarial Present Value [APV] (which may be referred to as Fair Market Value [FMV]) is calculated and RMDs attributable to that value must be taken out of another IRA or a commutation liquidation from the existing DIA contract. After ASD, the income payments from the DIA automatically satisfy the RMD requirement. No separate calculation is required.

**See also:**

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