By Anthony P. Curatola, Editor

Qualified Longevity Annuity Contracts and RMD Rules

The final regulations for the use of a qualified longevity annuity contract within a qualified retirement plan or an IRA will help taxpayers spread out their retirement funds.

The Internal Revenue Service (IRS) has issued final regulations for the use of a qualified longevity annuity contract (QLAC) within a tax-qualified defined contribution plan, a section 403(b) plan, an IRA, and eligible governmental plans. The final regulations allow the cost of the QLAC to be deducted from the account balance when computing the required minimum distribution (RMD) amount. This enables a taxpayer to spread out retirement funds from their account over a longer period because RMDs begin at age 70.5 and QLAC payments don't begin until age 85. The regulations are applicable to contracts purchased on or after July 2, 2014, and thus a person is able to reduce his or her RMD for 2014. But the clock is running out quickly for those taking 2014 RMDs.

These regulations don't apply to defined benefit plans because these plans generally offer annuities, which provide longevity protection. But the Treasury Department and the IRS are requesting comments to ascertain the desirability of forming a benefit that replicates the QLAC structure available in defined benefit plans.

The process that led to the issuing of the final regulations dates back to February 2, 2010, when 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. In general, the request included questions about how the RMD rules affect the interest of defined contribution plan sponsors and participants in the offering and use of lifetime income products. In particular, the request asked whether there were changes to the rules that could or should be considered to encourage arrangements under which participants can purchase deferred annuities that begin at an advanced age (sometimes referred to as "longevity annuities" or "longevity insurance").

Commenters responded that the RMD rules are an impediment to the use of deferred annuities beginning at an advanced age, and the Treasury Department and IRS agreed. As a result, proposed regulations were issued in 2012 (REG-115809-11) that allow individuals to purchase longevity annuity contracts within their defined contribution plans. The proposed regulations limited the amount dedicated to purchasing a QLAC to the lesser of 25% of the plan balance or $100,000. Moreover, the QLAC needed to begin making distributions to the plan owner no later than age 85. The proposed regulations were applicable for determining RMD on or after January 1, 2013.

Final regulations were issued on July 1, 2014, with corrections concerning the use of the QLAC issued on August 6, 2014 (TD 9673). In general, the regulations are consistent with the proposed regulations with a few taxpayer-friendly modifications. The critical modification pertains to the amount a plan owner can allocate from his or her plan to the purchase of the QLAC. Specifically, the maximum amount is increased from $100,000 to $125,000, so the limit is now the lesser of 25% of the plan balance or $125,000. This allows the owner to receive a larger annuity payment from the QLAC.

The final regulations also clarified the application of the 25% limit. It's applied with respect to an individual's account balance under a qualified plan as of the last valuation date preceding the premium payment, but any contributions to or distributions from the account made after the valuation date but before the premium is paid are factored into the value. In addition, the value of a QLAC is included in the account balance for determining the 25% limit even though the value is excluded when calculating the RMD amount.

Consider, for example, a 71-year-old plan owner who has an IRA with an account balance of $400,000 on December 31, 2013, and $480,000 on September 30, 2014. She can purchase a QLAC for up to $120,000 in December 2014, which is the lesser of $120,000 (25% of $480,000) or $125,000. As a result of the QLAC, the 2014 RMD for the plan owner is $10,566 (($400,000 – $120,000)/26.5), where the 26.5 comes from the Uniform Lifetime table appearing in Appendix C of IRS Publication 590. If the plan owner hadn't purchased the QLAC, her 2014 RMD amount would have been $15,094 ($400,000/26.5).

The final regulations made a few other modifications. A QLAC may provide a return of premium (ROP) feature to an annuitant's beneficiary if the annuitant should die before the first payment from the QLAC or if the annuitant dies after the annuity begins but before receiving an amount equal to the premium paid for the QLAC. In such cases, a QLAC may provide for a single-sum death benefit paid to a beneficiary in an amount equal to the excess of the premium payments made with respect to the QLAC minus the payments made to the taxpayer under the QLAC. If a QLAC is providing a life annuity to a surviving spouse (or will provide a life annuity to a surviving spouse), it may also provide a similar ROP benefit after the death of both the taxpayer and spouse. The ROP must be paid as a single-sum death benefit to the beneficiary no later than the end of the calendar year following the annuitant's year of death. That is, if the individual dies in 2014, the death benefit must be paid by December 31, 2015.

Another modification is if an annuity contract fails to qualify as a QLAC solely because premiums for the contract exceed the premium limits, then it won't be disqualified if the excess premium is returned to the non-QLAC portion of the taxpayer's account by December 31 of the year following the calendar year in which the excess premium was paid. The excess premium may be returned to the non-QLAC portion of the taxpayer's account either in cash or in the form of an annuity contract that isn't intended to be a QLAC. If the excess premium (including the fair market value of an annuity contract that isn't intended to be a QLAC, if applicable) is returned to the non-QLAC portion of the taxpayer's account after the last valuation date for the calendar year in which the excess premium was originally paid, then the taxpayer's account balance as of that valuation date must be increased to reflect the excess premium.

Likewise, if a contract at any time fails to be a QLAC for reasons other than exceeding the premium limitations, the contract won't be treated as a QLAC beginning on the date of the first premium payment for that contract.

The final regulations also contain a cost of living adjustment to the dollar limitation amount. The adjustment is at the same time and in the same manner as provided by IRC §415(d), except the base period is the calendar year quarter beginning six months before the effective date of the regulations and in $10,000 increments. The proposed regulations provided increments of $25,000.

There are a few items that commenters questioned in the proposed regulations but weren't changed in the final regulations. A variable contract, an equity-indexed contract, or similar contracts aren't QLACs. Also, a QLAC can't provide any commutation benefits, cash surrender values, or other similar features. Finally, the taxpayer must be notified that the contract is intended to be a QLAC.

The QLAC is attractive to many plan participants. It provides a guaranteed life annuity to the retiree while providing some protection for the premium paid. In addition, it reduces the RMD amount that a plan participant needs to withdraw annually. If an individual wants to take advantage of the QLAC for 2014, there isn't much time left for doing so. **SF**

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