Client Alert

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IRS Gives QLACs the Green Light: Final Regulations Issued

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On July 1, 2014, the Internal Revenue Service ("IRS") issued final regulations ("Final Regulations") that permit employers and IRA providers to offer "qualified longevity annuity contracts" or "QLACs" under defined contribution plans and IRAs. QLACs allow individuals to manage their retirement income by deferring payment of a portion of their retirement benefits to later in life. Individuals can apply up to the lesser of $125,000 or 25 percent of their defined contribution or IRA account balances to purchase QLACs. Payments under the QLAC begin at an advanced age (but not later than age 85) and continue through the remainder of the individual's life. QLACs may become a valued tool in retirement planning, but the new regulations leave unanswered certain key questions about their utility.

Final Regulations Provide an Exception to RMD Rules

The required minimum distribution ("RMD") rules under Internal Revenue Code ("Code") section 401(a)(9) require that distribution of an employee's qualified plan benefits commence by a required beginning date – generally, April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 ½ or retires. The Final Regulations provide an exception to the RMD rules by allowing participants to defer a portion of their RMD by purchasing QLACs up to specified premium limits. The value of the QLAC is ignored when calculating the participant's RMD, thereby lowering the amount of the participant's RMD payments.

Plans Permitted to Offer QLACs

Employer-sponsored defined contribution plans, such as 401(k), 403(b) and eligible governmental deferred compensation plans, and IRAs may offer QLACs and not run afoul of the RMD rules. QLACs are not available under defined benefit plans or Roth IRAs. Offering QLACs under a plan is optional for a plan sponsor.

QLAC Requirements

A QLAC is an annuity contract which is purchased from an insurance company for a participant. QLACs must comply with the following rules.

1. Premium Limits

The amount of premiums paid for a QLAC cannot exceed the lesser of $125,000 or 25 percent of the employee's account balance on the date of the premium payment. The Final Regulations include the following rules for applying these limits:

- The $125,000 premium limit is an aggregate limit that applies to all defined contribution plans and IRAs for that individual. The dollar limit will be indexed for inflation in $10,000 increments.

- The 25 percent limit generally applies on a plan by plan basis; however, individuals purchasing a QLAC for an IRA must aggregate account balances of all their IRAs when applying the 25 percent limit. The 25 percent limit is applied to an employee's account balance as of the last valuation date preceding the date of the premium payment, adjusted for subsequent contributions and distributions. The value of the QLAC is included in the employee's account balance for purposes of applying the 25 percent limit.

Excess Premium Payments. The Final Regulations protect individuals against accidental payment of premiums that exceed the 25 percent or $125,000 premium limits. An annuity contract will not fail to be a QLAC if the excess premium is returned (either in cash or in the form of an annuity contract that is not intended to be a QLAC) to the non-QLAC portion of the employee's account by the end of the calendar year following the calendar year in which the excess premium was paid. If excess premiums are not returned by the deadline, then the entire annuity contract will cease to be a QLAC as of the date of the excess premium payment.

If excess premiums are returned to the non-QLAC portion of the account after the last valuation date of the plan year in which it was paid, then the employee's account balance must be increased to reflect the excess premium for purposes of calculating the employee's RMDs.

2. Required Commencement Date

A QLAC must provide that distributions under the contract commence not later than a specified date set forth in the contract. This date must be no later than the first day of the month next following the employee's attainment of age 85. A QLAC is permitted to allow employees to elect an earlier annuity starting date than the specified annuity starting date.

3. Death Benefits

To encourage individuals to purchase QLACs and address concerns that payments under a QLAC will not be at least equal to the premiums paid for a QLAC, the Final Regulations permit – but do not require – QLACs to provide a return of premium (ROP) feature. This is an important change from the proposed regulations, which only permitted death benefits in the form of contingent life annuities payable to beneficiaries.

Return of Payment (ROP) Feature. A QLAC may provide for a single-sum death benefit to be paid to a beneficiary in an amount equal to the excess of the QLAC premium payment over the annuity payments actually made to the employee. If a QLAC is providing a life annuity to a surviving spouse (discussed below), it may also provide a similar ROP benefit after the death of both the employee and the spouse. The ROP payment must be paid no later than the end of the calendar year following the year in which the employee (or surviving spouse) dies.

Life Annuities Payable to Beneficiaries. If a plan does not include an ROP feature, then death benefits may only be provided as a life annuity payable to a beneficiary.

If the beneficiary is the employee's surviving spouse, the only benefit permitted to be paid after the employee's death is a life annuity payable to the surviving spouse that does not exceed 100 percent of the annuity payment payable to the employee. If the employee dies before his annuity starting date, then payments must begin no later than the date on which payment to the employee would have commenced if the employee had not died.

If the beneficiary is not the employee's surviving spouse, the only benefit permitted to be paid after the employee's death (other than an ROP) is a life annuity payable to the designated beneficiary. The life annuity is not permitted to exceed an applicable percentage of the annuity payments payable to the employee. The percentage is determined under one of two alternative tables in the Final Regulations. If the employee dies before his annuity starting date, then payments must begin by the last day of the calendar year immediately following the calendar year of the employee's death.

4. Contract Form Requirements

When a QLAC is issued, the contract (or a rider or endorsement, or a certificate issued under a group contract) is required to state that the contract is intended to be a QLAC. The Final Regulations include a transition rule for contracts issued before January 1, 2016. Such contracts will not have to comply with these form requirements so long as they are amended to comply with this requirement by the end of 2016 and employees are notified at the time of issuance that the contract is intended to be a QLAC.

5. Annual Disclosure Requirements

QLAC issuers must file annual calendar-year reports in a form to be prescribed by the IRS regarding the contract's status. Information required to be included in the annual report must also be furnished to the contract owner (or surviving spouse) on an annual basis.

Prohibited Features

Variable annuities and indexed contracts prohibited. QLACs are not permitted to provide variable annuities, indexed contracts or similar annuities. The preamble to the Final Regulations explains that the purpose of QLACs is to provide a predictable stream of lifetime income, which variable annuities and indexed contracts do not provide. QLACs may, however, be structured as a participating annuity contract (i.e., a contract that provides for the payment of dividends) or to provide for certain cost-of-living increases.

Cash value and similar features prohibited. QLACs are not permitted to make available any commutation benefit, cash surrender right, or other similar feature. The preamble to the Final Regulations explains that such cash value features would reduce the benefit of mortality pooling under the contracts.

Effective Date

The Final Regulations are effective July 2, 2014 and generally apply to contracts purchased on or after that date. If an existing contract is exchanged on or after July 2, 2014 for a contract meeting the QLAC requirements, the new contract will be treated as purchased on the date of the exchange, and the fair market value of the existing (exchanged) contract will be treated as the premium paid for the new contract.

Open Questions and Next Steps

The Final Regulations address many of the questions and concerns that plan sponsors and practitioners had about QLACs after the proposed regulations were issued. Perhaps the biggest unanswered question relates to the market for QLACs: Have the Final Regulations gone far enough to make QLACs an attractive product for plan sponsors, IRA providers and the insurance companies who would issue the QLACs? Only time will tell.

QLACs are presumably intended to be "portable," meaning that it should be possible for QLACs to be transferred from the plan or IRA in which they were purchased to another plan or IRA, either in a rollover transaction or in a trustee-to-trustee transfer. However, the Final Regulations do not specifically address the permissibility or the consequences of such transfers (for example, how such transfers would affect the QLAC premium limits applicable to the transferee plan or IRA). At a minimum, plan sponsors or individuals considering such transfers will need to work with their plan vendors and the insurance company issuer of the QLACs to make sure the transfers are feasible from a practical perspective.

Plan sponsors who are interested in offering QLACs under their qualified defined contribution plans will need to be aware of their fiduciary responsibilities to evaluate QLAC products in terms of contract features, pricing and the financial strength of the insurance company issuing the contracts. Sponsors will also have to coordinate with their plan recordkeepers and trustees to make sure the QLACs can be properly accounted for and custodized before offering QLACs under their plans.

If you wish to discuss the possibility of offering QLACs under your retirement plan or have any questions related to this Client Alert, please contact the Pillsbury attorney with whom you regularly work, or any of our Executive Compensation and Employee Benefits professionals listed below.

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