Offering Longevity Annuities in 401(k) Plans

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Responding to concerns that participants may outlive their retirement plan savings, the IRS recently finalized regulations facilitating the use of longevity annuity contracts in defined contribution plans. A longevity annuity is a deferred annuity under which payments begin at an advanced age, such as age 80 or 85, and continue for the life of a plan participant. Retirees can now safely purchase such an annuity paying a guaranteed lifetime income commencing at an age later than normal retirement using proceeds from a portion of their 401(k) accounts. To enable this, the final regulations relax the required minimum distribution (RMD) rules of Internal Revenue Code Section 401(a)(9) and establish the conditions for plans offering longevity annuities to qualify for this more lenient treatment. The IRS hopes that this will make it easier for defined contribution plans to offer such annuities.

Background

Before the final regulations were issued, longevity annuities were a problematic investment option for a tax-qualified plan because of the RMD rules. These rules provide that the minimum distribution amount is calculated by dividing a participant's account balance by his or her life expectancy and that distribution of this amount must generally commence no later than April 1 following the year in which the participant attains age 70½. Previously, when a participant's account included a deferred annuity contract, the RMD rules required that the value of the annuity contract be included in the account balance when determining the amount to be distributed, which meant a larger distribution than otherwise would have been the case. Moreover, if the entire account were invested in the annuity, there would be nothing left to make required distributions.

In February 2012, in an effort to promote longevity annuities, the IRS proposed regulations allowing the exclusion of qualifying longevity annuity contracts (QLACs) from the RMD calculation if certain requirements are satisfied. As summarized below, final regulations were issued in July 2014 that are largely consistent with the proposed regulations. The final rules apply to annuity contracts purchased on or after July 2, 2014. Under a special rule, a non-compliant contract issued before this effective date may be exchanged on or after July 2, 2014, for a new contract that satisfies the QLAC requirements.

QLAC Requirements

In order to qualify as a QLAC, an annuity must be purchased from an insurance company and the contract (or a rider or certificate) must state when it is issued that it is intended to be a QLAC. A QLAC must also provide that distributions thereunder can commence no later than the first day of the month next following the participant's attainment of age 85. A QLAC is not permitted to provide a variable annuity, indexed annuity, or similar type of benefit, since its purpose is to provide a predictable stream of income. In addition, QLACs may not provide a commutation benefit (*i.e.*, a lump-sum distribution), cash surrender right, or other similar feature. However, a QLAC can be a participating annuity that pays dividends or an increasing annuity that provides for cost-of-living increases.

Aggregate premium payments for QLACs cannot exceed the lesser of $125,000 (the dollar limit), or 25 percent of the participant's account balance (the percentage limit). In applying the dollar limit, premium payments under all qualified plans, as well as under 403(a) plans, 403(b) plans, governmental 457(b) plans, and IRAs (except Roth IRAs) maintained on behalf of an individual are taken into account. The dollar limit will be adjusted for inflation in $10,000 increments.

The percentage limit generally applies on a plan-by-plan basis and is determined with respect to a participant's account balance, including the QLAC's value, as of the last plan valuation date before each premium payment. The account balance is adjusted for any contributions or distributions made after the valuation date. In the case of an IRA, however, the percentage limit is applied to the total of the balances of all IRAs that an individual holds and, within this limit, QLAC premiums paid from a particular IRA may exceed 25 percent of that IRA's account balance.

The regulations contain a correction procedure in the event that a participant inadvertently exceeds the dollar or percentage limits. Under this procedure, excess premiums can be returned to the "non-QLAC" portion of a participant's account by the end of the calendar year following the calendar year in which they were paid without disqualifying the annuity purchase.

Optional Features

Under the proposed regulations, a life annuity payable to a designated beneficiary was the only permissible death benefit a QLAC could provide. To address participants' aversion to the risk of losing premium payments, the final regulations create an exception to this rule by permitting QLACs to offer a return of premium feature payable in the event the participant dies either before or after the annuity starting date without recovering the participant's premium outlay. Accordingly, a QLAC may provide for a single-sum death benefit payable to a beneficiary in an amount equal to the excess of the total premiums paid for the QLAC

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over the total payments made to the participant under the QLAC as of the participant's death. If the QLAC will provide a life annuity to a surviving spouse, it may contain a similar benefit after the deaths of both participant and spouse. The return of premium must be completed no later than the end of the calendar year following the calendar year in which the participant dies, or in which the surviving spouse dies, whichever is applicable.

Where a surviving spouse is the sole beneficiary, a life annuity payable to the spouse cannot exceed 100 percent of the payment the participant was receiving under the QLAC. However, where a participant dies prior to his or her annuity starting date, this payment may be increased to the extent necessary to satisfy the pre-retirement survivor annuity requirements. If there are beneficiaries in addition to the spouse, satisfaction of the minimum distribution incidental death benefit requirement limits a life annuity payable to a designated beneficiary.

As was the case under the proposed regulations, the final regulations also require annual reporting to the IRS by QLAC issuers.

Implications for Plan Sponsors

Making longevity annuities available to 401(k) plan participants will help them manage their retirement assets, but selecting a QLAC is a fiduciary act that will expose the plan sponsor to the risk of fiduciary liability. Accordingly, plan sponsors that decide to offer QLACs are advised to engage in an objective, thorough, and analytical process to evaluate QLAC features and pricing and select the QLAC issuer. A plan sponsor is advised to review the safe harbor established by the Department of Labor for selecting annuity providers and to monitor additional guidance expected from the Department. ❖

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