A Closer Look at QLACs

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Background

On July 1, 2014, the Department of Treasury and the IRS approved the use of a longevity annuity with qualified accounts, called a Qualified Longevity Annuity Contract (QLAC). It is important to note that the QLAC (pronounced cue-lack) is not a new product. The idea was actually introduced in 2004. Although, a QLAC is the result of a new IRS ruling of an existing product structure, the Longevity Annuity.

The QLAC strategy was primarily passed so that younger workers participating in 401(k)s could have the option to invest in a product that guarantees a lifetime income stream that started at a future date. The QLAC ruling also allows a person with a Traditional IRA to defer past the 70½ RMD age limit to a maximum age of 85 to plan for future income as well. I believe this will apply to the majority of QLACs sold because people can potentially lessen taxes on the RMDs.

What is a Longevity Annuity?

A Longevity Annuity is a fixed annuity that guarantees a future income stream at a date you specify. It is also commonly referred to as a Deferred Income Annuity (DIA). Some Longevity Annuity (DIA) contracts allow for you to defer as short as two years, and as long as 45 years.

Now, not all Longevity Annuities are QLACs. They have been around and sold in both IRA and non-IRA accounts. Some of my clients own them for future guaranteed income, but they do not own a QLAC. Just because it's called a Longevity Annuity doesn't mean that it is recognized as a QLAC. This is very important to know, and will be the center of confusion as the QLAC strategy starts being offered by more and more carriers. If you already own a Longevity Annuity, it can NOT be re-classified as a QLAC.

QLAC Ruling Summary

- Can be used in participating 401(k), 403(b), and governmental 457(b) plans
- Can be used in Traditional IRAs (non-Roth IRAs)
- Can NOT be used in pension plans, Roth IRAs or Inherited IRAs
- Can defer to a specific age, but no later than 85

QLAC Premium Limits

- 25% of total amount of all qualified accounts or $125,000, whichever is less
- The $125,000 limit is an aggregate amount of all IRAs and plans for one individual
- The $125,000 limit will be indexed for inflation and adjusted in $10,000 increments
- The 25% limit on IRAs applies to as many IRAs you may have. The IRS is looking at the total dollar amount.
- When it comes to 401(k), 403(b), and governmental 457(b) plans, the 25% limit applies to each participating plan with the $125,000 rule still in place

Death Benefits – ROP (Return of Premium)

QLACs can have death benefits, but are limited to specific structuring that can provide survivor annuity payments. If you die before the income stream starts, 100% of the initial premium will be returned to your listed beneficiaries in a lump sum. Even after you start taking income from a QLAC, the ROP feature applies as long as the death benefit is paid out under specific calendar year guidelines.

QLACs are pure transfer of risk lifetime income guarantees with principal protection of the premium, which is a pretty good deal! The ROP feature is available for both spouse and non-spouse beneficiaries. In addition to return of premium, you can also have a spousal QLAC beneficiary receive lifetime payments under specific provisions in lieu of ROP.

Spousal Benefits

One huge benefit is the fact that both you and your spouse can take advantage of the QLAC rules. Obviously, the spouse would have to possess their own qualifying IRA, but could also contribute 25% or $125,000 (whichever is less) into a QLAC contract. That's potentially as high as $250,000 per household that can be added to QLAC strategies!

QLACs will also allow you to add your spouse as a joint annuitant to the contract, which means the lifetime income guarantee is for both lives, regardless of how long either of you live. The contractually guaranteed payment will be lower because the carrier will be covering two lives, but I personally think it's worth it.

Beneficiary/Non-Spousal Benefits

QLACs allow you to list as many beneficiaries to the policy as needed. These beneficiary listings are revocable, and can be changed at the contract owner's discretion. Non-spouse QLAC benefits are a little more complex than spousal. You do have an option to guarantee payments to a non-spouse beneficiary, but the rules are a tad complicated and will also depend on the specific QLAC product and carrier you choose.

Cash Value Rules

One of the limitations of the QLAC strategy is that there is no cash value once the policy is purchased. In other words, you can't get to the principal except in payment form. Beware of the gunslinger financial advisor that will try to pounce on this sole issue of liquidity as justification to sell you something else with a higher commission.

How Payments Are Calculated

All annuity payments, including QLACs, are primarily based on your life expectancy at the time you start taking the payments. In essence, it's a bet between you and the issuing annuity carrier that you think you will live longer than they think you will live. What sets annuities apart from ALL other products is that the annuity company is on the hook to pay you regardless of how long you live. That's the benefit proposition of an income annuity, and the QLAC product offers the same transfer of risk security of knowing that you will never outlive your money!

In addition to your life expectancy, interest rates do play a complimentary role in the pricing of your lifetime payment.

Structuring the Payment

One of the common misbeliefs with annuity lifetime income streams is that if you die, the evil annuity company keeps the money. That is definitely not true with QLACs, and even with other annuities that provide a guaranteed lifetime income stream. It all comes down to how you structure the payment, and payments must start by age 85.

Like other annuity product offerings, QLAC issuers will have their own specific choices of how to structure the future incomes stream, and will allow you to customize the contract for both spousal and non-spousal guaranteed benefits. Because how you structure your QLAC at the time of application is so important, you need to have someone that knows the product inside and out, like Jean Ann Dorrell!

QLAC Account Variation Rules

According to the QLAC ruling, you calculate 25% or $125,000 amount on the date of payment into the QLAC policy using the prior year end total of your qualifying IRAs. This rule seems to apply to the Traditional IRA owner.

For a qualified plan participation utilizing a QLAC, the limit "is applied with respect to an employee's account balance under a qualified plan as of the last valuation date preceding the date of the premium payment."

QLACs in 401(k)s

For people that are still working and are participating in a 401(k) type defined contribution plan, you need to urge your administrator to offer QLACs within your specific plan. Defined benefit plans are not approved to use the QLAC strategy.

A potential issue for 401(k) participants is that the QLAC product is optional for plan sponsors to include in their plan. Hopefully, the drumbeat of demand will force most to offer the QLAC strategy within their retirement plan.

QLACs in Traditional IRAs

QLACs can be used in Traditional IRAs for lifetime income needs starting at a future date. QLACs in a Roth IRA make no sense because all money coming out of Roth is tax free. QLACs are not approved for use in Roth IRAs. However, a traditional Longevity Annuity (DIA) could work in a Roth for future income needs.

QLACs Can Potentially Help Reduce Your Taxes

Under the QLAC ruling, if you have a Traditional IRA, you can defer 25% of the total of all your IRAs or $125,000, whichever is less using a QLAC. That dollar amount can be deferred to age 85, and is not included when calculating RMDs. For example, if you have a $500,000 IRA, you could defer $125,000 under QLAC rules, and then be able calculate your RMDs on $375,000 instead of $500,000.

A quick reminder concerning RMD rules…Distribution payments have to begin by April 1st of the year that follows the year the IRA owner turns 70 ½. In addition, those payments have to be structured so that they will be completely paid out over the life expectancies of the owner and their beneficiaries.

QLACs could potentially help reduce those taxes you have to pay because your RMD calculations will be based on a smaller dollar amount. The only QLAC requirement is that payments have to start from the QLAC total at a specified date that is no later than 85. Paying less taxes is always a good thing, and QLACs could possibly help with this goal depending on your specific situation.

Defer Past 70 ½

RMDs are the equivalent of the IRS tapping you on the shoulder to "remind" you that it's time to start paying taxes on all of that money you've been deferring. With the QLAC strategy, you get to defer a little longer. QLACs allow you to defer 25% of your IRA total or $125,000, whichever is less, up to age 85.

Longevity Annuities in Non-IRA Accounts

Longevity Annuities, not classified as QLAs, can be purchased in non-IRA (same as non-qualified) and Roth IRA accounts. The strategy is the same, which means you can plan for lifetime income needs starting at a future date that you choose. I think that as the QLAC strategy grows in qualified plans, the Longevity Annuities in non-qualified accounts will grow as well. The Longevity Annuity strategy is so easy to understand that it will eventually be the gold standard of the annuity world.

QLAC Benefits – Review

- Principal protection via a fixed annuity structure
- Lifetime income guarantee regardless of how long you live
- No annual fees
- Simple and easy to understand
- Transparent contractually guaranteed proposal
- You can structure the policy to provide a legacy to your beneficiaries
- Younger workers in a participating 401(k) can plan for future income needs
- Traditional IRA holders can plan for future income needs
- You can defer up to 15 years, or age 85, with a Traditional IRA
- COLAs (Cost of Living Adjustments) can be added to the QLAC policy to contractually increase the income stream
- You can ladder QLAC contracts to have income starting at different dates
- Money can be added to the QLAC contracts (specific rules apply)
- Traditional IRAs, 401(k)s, 403(b)s and eligible governmental deferred compensation plans can offer QLACs

QLAC Limitations – Review

- Lack of liquidity
- No growth component during deferral years
- Rigid contract
- No cash surrender value
- Premium limits of 25% of your total IRA or $125,000, whichever is less
- QLACs are optional for 401(k) type plan sponsors
- Roth IRAs, Defined Benefit Plans and non-governmental 457 plans cannot house QLACs

QLAC Specific Example

Traditional IRA Example: $500,000 IRA, 70 year old male

- In this situation, the client is 70 years old which means he will have to start taking RMDs from his IRA starting at age 70 ½. With a QLAC strategy, he can take 25% or $125,000 (whichever is less) and defer the income stream to start as far out as age 85.
- So when he calculates his RMDs, the amount would be based on $375,000 instead of $500,000. Because it is a lesser amount, his RMDs will be lower. In essence, the value of the QLAC is ignored when calculating the RMD.
- With the $500,000 example, RMDs before implementing a QLAC strategy would be $18,250. After implementing a $125,000 QLAC, the RMDs would be $13,688. That's $4,562 less in taxable income! Hello!!
- The QLAC is principal protected in case he passes away before the income starts, and when he reaches age 85, a lifetime income stream will start. He can also choose to add his spouse as a joint life payout.

No Annual Fees

For the knee jerk reaction that "all annuities have high fees," this is simply not true. There are many annuity types that have no annual fees, and QLACs are one of them. No fees for the life of the policy. Yes, the agent gets paid a small commission that is paid out of the carrier's reserves, but buying a QLAC is a net transaction to you. Don't feel sorry for the insurance carrier because they have the big buildings for a reason!

Similar to a SPIA

Longevity Annuities and their QLAC cousin are structured very similarly to a Single Premium Immediate Annuity (SPIA). SPIAs provide what I call "Income Now," where a QLAC will provide "Income Later." Both are simplistic transfer of risk strategies that solve for lifetime income needs. QLACs and SPIAs have no fees, no moving parts, no market attachments, are both fixed annuities, and pay the agent a very low commission.

You Can Drink the COLA

COLA refers to Cost of Living Adjustment annual increases that can be attached to a policy. It's important to know and understand the basics of how a COLA works. At the time of application, you can choose a percentage that you would like the income to increase on an annual basis. For example, if you chose a 3% COLA, this means the income would increase by 3% every year for the life of the policy. Sounds like a no brainer, right? One of the reasons that insurance companies have the big buildings is that they don't give away anything for free. If you add a COLA to a policy, the carrier will simply lower the initial payout compared to the same annuity without a COLA. It all comes down to math, and your life expectancy.

No Money Left on the Table

One of the most common misbeliefs concerning annuities is that when you die, the evil insurance company keeps all of the money. This is totally untrue. What people are referring to is a "Life Only" payout structure, which is one of 15 different ways to set up the payout. Unless you tell me otherwise, I will structure your QLAC so that 100% of the money will go to you, your spouse, or your listed beneficiaries. The annuity company will NOT keep a penny.

Potential QLAC Speed Bumps

Because the QLAC structure is new for the carriers, there will most likely be some initial growing pains. In addition, because the IRS and the Treasury Department are majorly involved, government's track record for efficiency is not very good. Hopefully, these potential issues will not arise, and if they do, it will be temporary.

Why You Should Consider a QLAC

QLACs should be used primarily for lifetime income needs starting at a future date that you specify at the time of application. If your current 401(k) offers a QLAC choice, then you should definitely consider adding that to your asset allocation so you will have a guaranteed income stream in the future. If you are retired, or have a Traditional IRA, then you have two strategies where a QLAC can benefit your current plans. The obvious QLAC solution is for guaranteed income in the future, but another popular QLAC strategy will be to potentially lessen taxes on RMDs and deferring income past age 70 ½ in your Traditional IRA, and for as long as to age 85.

Another QLAC positive that also should be considered is that adding a QLAC policy to your portfolio shortens the time horizon on your other IRA investments because of the contractual guarantees and specific time horizon of the income stream. This allows you to potentially invest more aggressively because of the 100% contractual certainty of the QLAC policy. The QLAC also balances out the volatility of any other investment type future income streams.

For more information, go to www.TheSmartMoneyGal.com or call 352-307-8652. Schedule a free consultation to talk with Jean Ann Dorrell about QLACs!

About the Author:

Jean Ann Dorrell began a career in the insurance and annuity industry in 1991. She has achieved numerous designations and awards. Since 2005, Jean has been awarded continuous membership to the Million Dollar Round Table elite group "Top of the Table." MDRT is an international, independent association for leading life insurance and financial services professionals.

Jean has achieved the prestigious Certified Estate Planner designation under the direction of the National Institute of Certified Estate Planners (NICEP). NICEP is nationally recognized by many of the industry's top Broker/Dealers, Insurance Companies, and numerous professional financial, legal, and tax service organizations that are involved in the area of estate planning. You can find Jean on NICEP's website at www.nicep.org.

Jean is also a published author of the book, "Don't Be A Victim! Protect Yourself!"

Jean is has been a regular Saturday morning guest on Fox 35's Good Day Orlando in The Money Watch Segment, where she contributed valuable information regarding your financial future. Visit www.TheSmartMoneyGal.com to watch previous news segments.