QLACs
Practically Speaking

Qualified Longevity Annuity Contracts offer many positive opportunities. But potential challenges exist as well. Here's how to find your way home.

BY PAUL KOCIURUBA WITH JOHN P. ASHFORD

At the beginning of a recent business trip, I was picked up by an elderly gentleman who was transporting me from my house to the car rental company. As is true for most sales folks, I like to strike up conversations and find out about people and their lives. The 73-year-old man's name was Henry. As we were riding I asked him how long he had been working for the car rental company. He said right at 11 years. Henry said he had done many jobs during his career, from washing cars to transporting folks like me.

I was intrigued, so I asked him what he did prior to this position and he explained that he worked at a textile mill for 42 years. That may have explained why he was wearing hearing aids. Now I know that not everyone who worked in textiles needs hearing aids — but for those who have (including myself back in high school and college), the sound of the looms over the years (even if one had worn ear plugs) has to take a toll.

Since the retirement space has been my business for 25 years, I had to ask him about the company he was with for 42 years and whether they had a retirement plan. He told a story we hear all too often: The company had a retirement plan, but went bankrupt and got rid of their pension plan during the tough years. I didn't want to delve too deeply; only seeking to understand some things like the history and vesting — and about the PGBC, since he left the company with only $5,000 for retirement. I didn't ask about his desire to work at age 73. My philosophy has always been that if I work after retirement (and I probably will), it will be because I choose to. *Choose.*

In my 25 years in the retirement industry, I have witnessed many changes. Some say change is the only constant. For many different reasons, those constant changes have evolved and here we are now. The good news is that statistically we are all living longer — an average of 78 years to be exact. In the 1930s, life expectancy was 58 for men and 62 for women.

Of course, having a longer life expectancy is a good thing, but it also creates many challenges. One of these deals with the amount of income needed at retirement — and now that we are living longer, needing it for an average of 13 years after we retire.

We all know the history of Social Security and the struggles to keep up with the increasing number of retirees. Do you think FDR and the Treasury envisioned this back in 1935 when Social Security was created? Probably not, since the life expectancy was almost 20 years less than it is today and the number of working folks versus those who were retired was about four times greater.

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Because it is in the news so much, we also know that Baby Boomers have started retiring; their numbers will do nothing but increase over the next 14 years.

And we know about the history, challenges and changes in the pension market. Gone are the days when we work for ABC Company for 42 years, get a gold watch at retirement, receive a pension, and ride off into the sunset with our retirement needs taken care of by our employer.

Challenges like these create opportunities for innovation. The retirement industry has accepted this challenge with much study of history and the invention of new products. One of the products that has been introduced, after much study and debate by the IRS and Treasury, is the Qualified Longevity Annuity Contract (QLAC).

A QLAC is purchased within a traditional retirement plan or with qualified money (*e.g.*, an IRA), allowing the annuity payments to be deferred until the person reaches a more advanced age. The basic QLAC rules include:

- income must be started by age 85;
- the value of the QLAC is excluded from retirement value when calculating required minimum distributions (RMDs) once you reach age 70½ (more on this below); and
- the limit on purchasing a QLAC is 25% of the account value or $125,000.

So basically it is a contract with an insurance company that pays a monthly income for life at an advanced age. Think of it as longevity insurance.

LET'S TALK NUMBERS

Let's look at someone who has $500,000 in her account and wants to put the maximum in her QLAC. Twenty-five percent of the account balance ($125,000) is the limit. Obviously one of the primary purposes of the QLAC is to enable you to delay taking a fixed amount of your retirement savings while (hopefully) being able to maintain your standard of living through retirement. The regulations also allow, in the event of your death before the QLAC kicks in, to pay the income to a spouse or other named beneficiary. Another option is to pay back the amount paid into it, a "return" of premium upon your death.

Knowing what a QLAC is, its corresponding limits, and what it can be used for, would you think the IRS and DOL might be interested in this solution? They are aware of the pressure on Social Security, people living longer, pensions disappearing, and the cost of living increasing. And they know that we are seeing people running out of money in retirement and that the average 401(k) balance isn't nearly high enough.

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From a practical standpoint, I think people see the value of guaranteeing an income for later on in life. Of course, this isn't like life insurance where the insurance company is betting we live and we are betting the opposite. In this case, we are betting on our good genes (and avoiding getting hit by the proverbial bus) and, knowing that we are going to need income later on in our retirement years, believing that putting a portion into a QLAC will help. Personally, I think it will also help prevent having to draw down our money too soon, as well as not having to live below our means.

But it would be naïve to think that these would be the only reasons for purchasing a QLAC. Even though the contribution limit isn't that great, I can see it being used as a tax strategy, and a pretty good one at that. Being able to avoid RMDs on this amount of money is smart and enables you to do more with your non-qualified assets prior to using the QLAC. It may also enable a retiree to claim Social Security benefits at their normal retirement age, easing some of the fears about the changes that are coming.

However, while there are positive opportunities because of QLACs, there are also potential challenges, such as consumer confusion, record keeper stability, participation from younger folks, cost in annuities from RMD calculation, and keeping up with the calculations (e.g., amounts and payouts).

Let's look at some of the specific considerations in offering QLACs in group retirement plans.

AVAILABILITY

First, there is no product currently available for use in qualified defined contribution plans. The QLAC products as of this writing are only available for IRAs, and are offered by a total of just three providers. In addition to availability, we have all of the factors below to consider upon implementation.

GETTING THE PLAN READY FOR A QLAC

Before a QLAC is included as an investment option in a qualified plan, there may be a few modifications required of the plan document. An amendment may be necessary to allow QLACs as an includable investment type within the plan. There could also be an amendment to the language to accommodate the exclusion of the value of the QLAC when calculating the RMD. This should be reviewed with the provider of the document or TPA to ensure all is in good order.

REPORTING AND DISCLOSURE

Another consideration is whether record keepers will be willing to accommodate this holding or if it will all fall on the TPA to manage. I see it initially as being a function served by the TPA. The TPA must be flexible and accommodating to the inclusion of the product within the plan and to satisfy all operational requirements.

Within the new regulations of the product is another reporting requirement (with Form 1098-Q) to accompany the qualified plan world of notices. Will the mandatory participant reporting requirement for a QLAC from the issuer be sufficient, or will this need to be incorporated into the summary annual notice process as well?

Who's Interested in QLACs?

According to research data, the poorer and younger you are, the more likely you are to be interested in a QLAC — except if you already have a retirement plan.

Interest in a QLAC peaks at about 63% for workers 45 or younger, according to tabulations from the Employee Benefit Research Institute's 2015 Retirement Confidence Survey. Fewer than 40% of workers over age 45 expressed interest, except among those with less than $20,000 in household income.

Longevity perceptions also made a difference in QLAC interest: Nearly twice as many of those who thought it was very likely they would live until at least age 85 were interested in QLACs as among those who believed it was not at all or not too likely (47% versus 25%). While one might expect that interest gap to close as individual longevity expectations rose, it basically held up even among those who thought it was very likely they would live until 95 (53% versus 30%).

Not surprisingly, survey respondents with a retirement plan — DC, DB or IRA — were less interested in a QLAC than those without one. Nearly half (47%) of those with a plan were *not* interested; and 39% *were* interested.

ADMINISTERING THE LIMITS

To review, the limit requirements are 25% of the participant's plan balance, not to exceed $125,000 in the aggregate. How will this requirement be managed? The sponsor is responsible but, as always, will rely on support from those providing administrative services to the plan.

The contribution limit is pretty basic for the benefit, which provides a maximum contribution outlay of 25% of the participant plan account balance (as of the last valuation). This will require diligent monitoring of

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the contributions, especially when it is part of current active salary deferrals, which can very easily slip into an over-contribution. As long as a correction is made prior to the year end following the year in which the over-contribution occurred, all is well.

After an internal operational control for this is established, we now have to become inclusive managers of the overall contribution limit of $125,000. This forces us out of the confines of the qualified group retirement plan and into the total universe of allocations the participant may have outside of the plan to determine if the aggregate limit has been reached. It appears that we will be able to rely on the disclosure by the participant for this information, but will it really limit the sponsor for liability of an over-contribution based on the information that was provided?

With all involved, there will be increased servicing time and newly enacted processing parameters by the TPA. Involving a proactive, critical thinking TPA with flexible and diverse operational services will initially be required to ensure all the requirements are met.

FIDUCIARY CONCERNS

Sponsors need to be prudent in the selection of the provider of the product contract. Prudence of product sustainability by the provider is possible, but prudence of the cost will be limited to the players that will eventually enter into the qualified plan market. Portability will be a concern as well, as there will be a limited number of plans offering this benefit or capable of receiving the contract on behalf of the participant. Those plans capable of receiving the QLAC may not have a plan sponsor willing to accept a contract that was not part of their selection process. The most probable event will be the participant contract being rolled over into an IRA with the issuer.

CONCLUSION

The federal government has created an atmosphere of promotion for QLACs, emphasizing their pension-like nature as a benefit to participants. Currently the firms issuing QLACs are only offering the product to individual IRAs. Maybe this is where the benefit will be most prominent, but the hopeful outcome for the qualifying regulation was to have it introduced into group qualified plans, touching more individuals.

It will be a seesaw of give-and-take. Surveys, including one from Hewitt, show that approximately 80% of plan participants want retirement income products and about an equal percentage of sponsors are not planning to provide them. Taking the "glass half full" approach, it appears that 12% of sponsors will consider moving in the direction of providing an annuity option in the near term.

Modifications necessary to include QLACs in qualified defined contribution plans can be absorbed and served through marketplace evolution; our industry adapts to change very well. All in all, we are in a good position to address this need once a product is developed.

We hope this nominal review will provoke further thought about QLACs, practically speaking. They are all about tomorrow, but the needs to be addressed are for today. PC

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