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What Is a Qualified Longevity Annuity Contract?
By Stephen Silverberg, CELA, CAP, and Scott B. Silverberg, Esq.

A few things Elder Law attorneys should know about this new investment option.

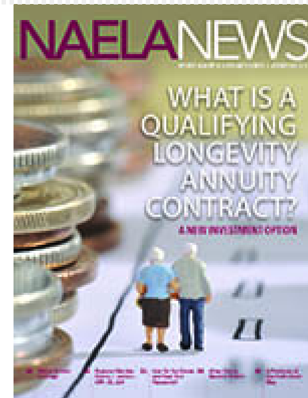
A Qualified Longevity Annuity Contract (QLAC) is a new investment option that Elder Law attorneys should be aware of. Although most Elder Law attorneys should not offer investment advice, we should know enough to make referrals when necessary. With this article, we're only touching the tip of the iceberg in terms of understanding how a QLAC will interact with Medicaid and tax law.

Two Ends of the Retirement Spectrum
A QLAC was designed to serve two primary purposes at different ends of the retirement spectrum. First, it provides a way for persons concerned with not having enough income in later years of their retirements to ensure an additional income stream. Second, it allows retirees in the early years of their retirement to reduce their Required Minimum Distributions (RMD).

QLACs may be very attractive, but clients and advisors should realize that like other tools they are appropriate for some situations and not for others. It may be attractive to a 70-year-old who is still working or has a substantial income flow while being inappropriate for someone whose resources are extremely limited. We will review some of the general comments that have been made about QLACs but will emphasize a topic not commonly addressed, the consequences if the retiree might need to apply for Medicaid in the future. Unfortunately, the answers are not always so clear because there has been little clarification of consequences, in part because QLACs are so new.

Not Well Known Even by Experts
QLACs are presumably not that well known even by experts. At a recent meeting of the ERISA Advisory Council of the United States Department of Labor (which author Stephen Silverberg attended), a panel of behavioral psychologists reported many seniors feared outliving their resources.

Not mentioned was the Internal Revenue Service's July 21, 2014, final rules regarding QLACs.[1] Previously, IRA account holders were governed by the RMD rules in IRC §401(a)(9) and the regulations promulgated under that section. In



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effect the Advisory Council ignored a vehicle designed to address the problem they were discussing.

In 2012, 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.[2] Based upon written submissions and public hearings, the IRS issued these final rules. Although these new rules apply to IRA accounts and all employer-sponsored plans such as 401k, 403b, or 457b plans, the focus of this article will be IRA accounts.

What Is a QLAC?

A QLAC is an annuity purchased from an insurance company with a portion of the assets of the IRA not to exceed the lesser of 25 percent of the account balance or $125,000.[3] The account holder can defer the cost of the annuity from RMD calculations for a period of years but no later than the month after the account holder attains the age of 85 years. For the 25 percent test, all IRA accounts maintained by an individual are aggregated. In theory, this provides additional resources later in life; however, there are numerous rules and a QLAC may seriously affect Medicaid liability. Previously, QLACs were not permitted since they could not meet the RMD requirements of IRC §401(a)(9). A QLAC can be for the life of the account holder or the joint life of a designated beneficiary.

To be a QLAC, besides the premium limitation, the annuity must meet the following requirements:[4]

1. The contract provides that distributions under the contract must commence not later than a specified annuity starting date that is no later than the first day of the month next following the 85th anniversary of the employee's birth;

2. The contract provides that, after distributions under the contract commence, those distributions must satisfy the requirements of this section;

3. The contract does not make available any commutation benefit, cash surrender right, or other similar feature;

4. It provides no benefits under the contract after the death of the employee;

5. When issued, the contract states that the contract is intended to be a QLAC;

6. The contract is not a variable or an indexed contract, or a similar contract although a cost-of-living adjustment is permitted; and

7. The issuing insurance company must file annual reports on the QLAC to the IRS and copy participants.

A QLAC can be purchased before or after the required beginning date but is subject to the age 85 limitation. Given that QLACs are not subject to commutation, it may be less attractive to those younger than age 70.

On paper, the ability to increase IRA distributions upon attaining a predetermined age sounds attractive. If one assumes a 6 percent return (an amount easily attained in a tax-free IRA account under professional management) with RMD's commencing in 2016, the IRA account will increase in value until 2032 when the account holder is 86 years. It is at this point the RMD's will decline. If a portion of the IRA is used to purchase a QLAC at the time RMD's commence, in 2031, the account holder would then receive payments from the QLAC in addition to their RMD.

The issue lies in the internal rate of return of the QLAC. Upon purchase, the rate of return of the QLAC will be affected by commissions and other administrative costs. The internal rate of return of a QLAC over the entire timeline of the QLAC must exceed the rate of return of the invested IRA assets.

Insurance companies can offer several optional riders heralded as benefits of a QLAC. The first is a cost-of-living adjustment similar to the one allowed in traditional IRA accounts.5

A QLAC can also offer a Return of Premium (ROP) option. The ROP guarantees upon the account owner's death, the beneficiary receives an amount equal to the premium paid for the QLAC less the total annuity payments received by the account owner.6 An ROP following the death of account holder must be paid no later than the end of the calendar year following the calendar year in which the account holder dies. If the account holder's death is after the required beginning date, the ROP payment is treated as a required minimum distribution for the year in which paid and is not eligible for rollover.7

When there is an ROP following the death of a surviving spouse receiving a life annuity (or after the death of a surviving spouse who has not yet commenced receiving a life annuity after the death of the employee), the ROP payment must be made no later than the end of the calendar year following the calendar year in which the surviving spouse dies. If the surviving spouse's death is after the required beginning date for the surviving spouse, then the return of premium payment is treated as a required minimum distribution for the year in which it is paid and is not eligible for rollover.8

A QLAC can be purchased for the joint life of the account holder and a designated beneficiary. In addition to the ROP option, the designated beneficiary may receive a life annuity. There is a difference in treatment if the sole beneficiary of the QLAC is the surviving spouse. If the account holder dies either before or after the QLAC starting date, the surviving spouse can receive a life annuity equal to the amount the account holder would have received. The life annuity payable to the surviving spouse must commence no later than the date on which the annuity payable to the account holder would have commenced under the contract if the account holder had not died.9

If the surviving spouse is not the sole beneficiary, the life annuity amount is equal to the payment to the account holder reduced by a percentage based on the age

difference between the account holder and the beneficiary.[10] This schedule is contained in Reg. §1.401(a)(9)-6, Q&A-17(c)(1)(iii).

QLAC and Medicaid

The effect a QLAC on Medicaid benefits is not clear from a legal or practical point of view. Since the QLAC is a new product, there is no track record. An examination of the applicable statutes reveals numerous apparent conflicts and ambiguities.

For Medicaid purposes, since it is the purchase of an annuity with the proceeds from an IRA account, it is exempt from the requirements of being irrevocable, actuarially sound, and require equal payments.[11]

However, it still must either name the State as the remainder beneficiary to the extent of the cost of medical assistance paid on behalf of the account holder or the State is the secondary beneficiary after a community spouse or a minor or disabled child.[12]

The potential for confusion is great as the purchase of a QLAC alters the distribution rules for the QLAC. As previously stated, a traditional IRA is governed by the defined contribution plan distribution rules contained in Reg §401(a)(9)-5. When purchased, a QLAC is subject to the distribution rules covering defined benefit plans in Reg §401(a)(9)-6. Unlike traditional IRA accounts, there are no distribution tables or formulae. The actual payment from the QLAC is the RMD.[13] As a result, the typical familiar IRA distribution rules, such as the age of the designated beneficiary, do not apply. IRC § 1.401(a)(9)-6, A-17(c)(2)(v) states:

A contract is described in this paragraph (c)(2)(v) if the contract provides that if the beneficiary under the contract is not the employee's surviving spouse, benefits are payable to the beneficiary only if the beneficiary was irrevocably designated on or before the later of the date of purchase or the employee's required beginning date.

This would appear to allow the State to be named a remainder beneficiary. Will this language allow the State's interest to be limited to the amount owed the state? This is far from clear.

There may also be a timing issue. If a person enters into a QLAC contract at age 70 and needs Medicaid assistance a decade or more later, what happens? Was there a divestment beyond the window for penalties? Presumably, there is no ability to add the State later. Should everyone assume that Medicaid is a risk and add the State as a matter of course?

This article only touches the tip of the iceberg for the Elder Law attorney. It might be wise to avoid QLAC until there is further clarification of the interplay between the Medicaid and tax law.

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Citations

1 Internal Revenue Bulletin, TD 9673, July 21, 2014.

2 75 FR 5253.

3 Reg. §1.401(a)(9)-6, Q&A-17(b).

4 Reg. §1.401(a)(9)-6, Q&A-17(a).

5 Reg. §1.401(a)(9)-6 Q&A-14(b).

6 Reg. §1.401(a)(9)-6, Q&A-17(c)(4).

7 Reg. §1.401(a)(9)-6, Q&A-17(c)(4)(iii)(A).

8 Reg. §1.401(a)(9)-6, Q&A-17(c)(4)(iii)(B).

9 Reg. §1.401(a)(9)-6, Q&A-17(c)(1).

10 Reg. §1.401(a)(9)-6, Q&A-17(c)(2).

11 42 U.S.C.A. § 1396p(c)(G).

12 42 U.S.C.A. § 1396p(c)(F).

13 26 CFR 1.401(a)(9)-6 , A-1(a); 26 CFR 1.401(a)(9)-5, A-1(e).