Life Just Got Easier for Qualified DIAs

By Kerry Pechter *Thu, Jul 3, 2014*

The new Treasury regulation on "longevity insurance" does more than promote late-life annuities. By removing an RMD barrier, it makes retirement income planning easier for middle-class people whose savings are mainly in qualified plans or IRAs.

The new Treasury regulation that relaxes the required minimum distribution (RMD) rules for qualified deferred income annuities (DIAs) was not exactly the regulation that I and some other observers had expected. The regulation, announced this week, was broader and potentially much more useful.

I expected the new regulation to allow near-retirees or retirees to use some of their IRA or 401(k) money to buy so-called "longevity insurance"—life-only annuities whose payments began *no earlier* than age 80 to 85. Instead, it allows people to spend up to $125,000 on DIAs whose payments don't have to begin *until* age 85. What's more, the DIAs can offer return-of-premium death benefit options.

In short, qualified DIAs sold after July 2, 2014 (the regulation isn't retroactive) will offer much more flexibility. Contract owners won't have to start taking income from them by age 70½, when RMDs from their other tax-deferred accounts must begin. (DIAs purchased with after-tax money aren't subject to RMDs, so they aren't affected by the new regulation.)

For instance, a 66-year-old with substantial savings in a 401(k) or rollover IRA can now put 25% of that savings (up to $125,000) in a DIA with a ten-year deferral and postpone taxable distributions until age 76. (This type of DIA will be henceforth known as a Qualifying Longevity Annuity Contract, or QLAC—a mouth-filling new acronym that embodies their kinship with QDIAs. Both are blessed for use as options in qualified retirement plans.)

That's fairly good news, especially at a time when people are expected to work longer, live longer, and neglect to think about structuring their retirement finances until they reach their mid-60s. It won't necessarily be a game-changer for leading DIA marketers like New York Life, MassMutual, Northwestern Mutual but, as one product manager told *RIJ* yesterday, it could give qualified sales a lift.

An idea evolves

Shame on me for sleeping on the job and expecting a narrower regulation. I was still relying on these words in the *Federal Register* back in 2012:

"The Treasury Department and the IRS have concluded that there are substantial advantages to modifying the required minimum distribution rules in order to facilitate a participant's purchase of a deferred annuity that is scheduled to commence at an advanced age—such as age 80 or 85—using a portion of his or her account."

That sounded like a direct reference to pure longevity insurance—low-cost, long-dated, life-only contracts that cover catastrophic longevity "tail risk," the kind of insurance that people should buy and stuff in a drawer, just as they stuff termite or flood or meteorite insurance contracts in a drawer.

Indeed, other sensible people assumed the same. John Turner, director of the Pension Policy Center in Washington, D.C., thought what I did. In early 2013, he and David McCarthy published an article about the proposed regulation in *Benefits Quarterly*. The authors equated the product under discussion at the Treasury with an annuity that "starts at an advanced age, 85."

"It is very strange that they completely changed the concept from one where it seemed that you had to be at least age 80 to receive payments to one where you can be age 72," Turner told *RIJ* yesterday, as he was packing to go on vacation. "In my analysis of the proposal, it was clear to me that such an early age was not envisioned." (He doesn't think men should buy DIAs through 401(k)s, because the unisex mortality tables used to price in-plan annuities work against them.)

But Turner and I obviously weren't paying close enough attention to the comments that had been filed in response to the proposed regulations two years ago. In their filings and discussions with officials, annuity experts and industry attorneys were evidently telling Treasury what every close observer of DIAs knew by then. Which is that consumers didn't like pure, life-only, long-dated longevity insurance, but seemed to love *deferred income annuities*—personal pensions with optional death benefits.

Thus we have a regulation that's aligned with the reality of the marketplace, instead of one that merely tries to create a market for an idealized product that nobody wanted. Moshe Milevsky, the York University annuity expert and consultant who was close to some of these discussions, reminded *RIJ* that nothing in the new rule prevents people from buying pure longevity insurance.

"If you want, you can still purchase the 100% pure ALDA [advanced life deferred annuity] that starts payments at age 80 or 85," he wrote in an e-mail. "What they [the Treasury

department] are allowing is for someone to add [death benefit] riders and still qualify for QLAC treatment—which then opens the market to a much wider set of products as well (e.g., the DIA.) Basically, the intention was to increase the size of the market beyond what was allowed in the proposed regulations, but not too wide.

"Initially my position was that a QLAC should offer no death benefits, no return of premium, and no ability to turn-on income early, so that it could offer the highest amount of mortality credits possible. That said, I can understand the pressure from industry groups and practitioners who claimed that nobody—other than a few economists—would want to sell or buy these things. There was a need to compromise and allow for features that would make the product easier to sell," he wrote.

The death benefit mattered

Perhaps sensitive to this point, the Treasury Department fended off any suggestion that its final regulations were shaped by industry pleadings. The official response was that the final regulation in 2014 promised nothing more or less than the proposed regulation had in 2012: that payments could "start no later than age 85." In fact, the proposal had never referred to a minimum payout age.

A spokesman for one of the lobbying groups that commented on the proposal told *RIJ*, "Our regulatory affairs folks don't believe that Treasury ever intended there to be a certain commencement age. It seems that they always wanted there to be flexibility. But at the same time, the longer the deferral period, the further you get beyond age 70½, and the more helpful this QLAC rule becomes. This might be why some folks had age 80 or 85 in mind."

Others suggested that once the Treasury Department decided to expand the definition of a QLAC to include an optional return-of-premium death benefit, the point of pushing back the earliest start date to age 80 made no sense. The death benefit had already removed some—though not all—of the mortality credit. And, from a revenue standpoint, the government clearly had no interest in forcing people to *delay* taxable distributions to age 80. If they only want to defer to age 73, that's a relatively easy dispensation to grant.

On the contrary. In a prepared statement, Mark Iwry, the deputy assistant Secretary of the Treasury for retirement and health policy, addressed that issue:

"The extent to which a deferred annuity presents challenges in terms of RMD compliance—and the special treatment under the RMD rules that the regulations provide—is

generally proportional to the lateness of the annuity starting date," his statement read. "An annuity that starts at age 85 presents a greater RMD compliance challenge and receives special treatment under the regulations for a longer period of years than one that starts at age 75. The regulation does not create a 'cliff' that would limit special RMD treatment to annuities starting after a specified age."

Besides the death benefit, the retirement industry also requested and got from Treasury a softening of the proposed rule that over-contributions to a DIA would nullify the contract. According to the final regulations, over-contributions can be corrected.

But the industry didn't get everything it wanted from Treasury. Although the final regulations allow as much as $125,000 to be spent on a QLAC (up from $100,000 in the proposal), Treasury didn't accept the industry argument that the 25% cap on deferral made it tough for someone with, say, $200,000 in qualified savings, to buy a meaningful income stream.

Some sectors of the industry came away empty-handed. Representatives of the fixed indexed annuity lobbied for the new QLAC regulation to include their products, so that FIA contract owners could postpone RMDs until their living benefits entered the income stage. But Treasury rejected the plea, at least for now, on the grounds that the equity-linked lifetime withdrawal benefits are variable, and the products not easy for retirees to compare. (Oddly, there was no mention of the distinction that DIA contracts are irrevocable and illiquid, while living benefits are liquid.)

Kim O'Brien, president and CEO of the National Association of Fixed Annuities, isn't satisfied by that answer. She sees no difference between DIAs and FIAs big enough to justify the exclusion of FIAs from being QLACs.

"If Treasury allows a 'holiday' from RMDs for DIA owners between age 70½ and an undefined 'maximum age' that 'may be adjusted to reflect changes in mortality,' then any product with a 'predictable income payment' should be allowed," O'Brien wrote in an email to *RIJ*. "We are still reading through the entire Rule and will have more information as we get through it." The Treasury Department did not rule out giving FIAs an exemption. Interestingly, Treasury did extend the QLAC designation to Northwestern Mutual's DIA, which has a variable payout in the sense that contract owners can receive annual dividends along with guaranteed income.

The proponents of in-plan annuities got what they wanted from the new regulation, but it

won’t be enough to fulfill their needs. Cynthia Mallett, a vice president at MetLife, has been working for several years to get deferred income annuities approved as options in 401(k) plans. She saw the new regulation as an important step toward that goal. But the regulation doesn’t resolve an even larger barrier to in-plan annuities: plan sponsors’ reluctance to offer them without a “safe harbor” rule from the Labor Department that would hold them harmless if the annuity issuer went bust.

Still, Mallett was gratified by the new regulation. For much of the past decade, she said, she and others had worked to get legislation introduced that would remove the hurdles to qualified DIAs. But their proposed bills repeatedly fell victim to a political environment where bipartisan initiatives don’t have much chance of passage. Appealing to a retirement-friendly Treasury Department for a regulatory change (as opposed to appealing to Congress for a legislative change) turned out to be much more productive.