QLAC Status for VAs and FIAs: Yea or Nay?

By Kerry Pechter *Thu, Dec 11, 2014*

"Trying to make a deferred annuity with a GLWB into a QLAC amounts to contorting it into something it isn't and shouldn't be," said John Olsen, co-author with Michael Kitces of The Advisor's Guide to Annuities.

Should variable and indexed annuities with lifetime withdrawal benefits (GLWBs) be given status as "qualifying longevity annuity contracts" (QLACs) for IRAs and DC plans?

'No' was the answer from all of the participants in a recent LinkedIn discussion that was initiated by Retirement Income Journal and occurred in the Retirement Income Industry Association's LinkedIn group. The results may have been skewed, however, because no one from an issuer of VAs or FIAs appeared to take part in the discussion.

The Treasury Department left some ambiguity regarding VAs and FIAs earlier this year when it announced the creation of qualified longevity annuity contracts, or QLACs. A QLAC is a deferred income annuity, purchased with up to $125,000 in pre-tax savings, that starts providing income after age 70½ (but before age 85).

Before QLACs, qualified DIAs could rarely be issued for income starting after age 70½ because their illiquidity made it impossible to take required taxable distributions from them during the deferral period.

The final IRS regulations on qualified DIAs specifically excluded VAs and FIAs from the rule. But they also said that the IRS could at some point give owners of those products the same privilege. When asked, Deputy Treasurer Secretary Mark Iwry, the architect of the QLAC regulation, didn't deny the possibility.

"This is a final reg, but this is not a final step in this whole process of regulation," he said. "In no way is this intended to suggest that variable products or indexed annuities don't have a potentially important and very constructive place to play, nor to suggest that they would not be part of similar guidance that's issued in the future."

A logical 'No'

The LinkedIn discussion took place in the Retirement Income Industry Association group, so there was nothing scientific or broadly representative about the range of responses to the question on QLACs. But of those who chose to take part in the discussion, none argued in favor of including VAs and FIAs in the rule.

"This is a logical NO," wrote Curtis Cloke, an Iowa-based advisor who pioneered the use of non-qualified, period-certain DIAs to create floor income for high net worth retirees. "QLACs cannot have cash value, only an income value. The point of a deferred annuity with a GLWB is to potentially grow and retain assets during the income delay period. The fact that a QLAC DIA has no cash value is the very reason that there is no RMD requirement during the income deferral phase, after age 70½ and no later than age 85. Any deferred annuity with GLWB cannot pass this test. If one wants opportunity for market adjustments, there may be variable rate QLACs in the future. Or one could add a [cost of living adjustment of 2% or 3%]."

Jim Dobler, national sales manager of CANNEX, the Toronto-based provider of annuity pricing data of U.S. and Canadian products, suggested that VAs and FIAs are complex products that would raise new and difficult questions for regulators and clients.

"What if the deferred annuity clients reached age 85 and did nothing?" he wrote. "Would they be forced to start the living benefit? In my opinion, we'd be moving away from what the QLAC is looking to accomplish when we use anything except a DIA.

"My biggest concern is that the carriers keep making more complicated products. Most advisors, let alone their clients, have no understanding of how they work. If there were more education in the industry on how these products work and how they fit in a client's portfolio, I could really see value. Unfortunately, that is severely lacking across the board."

John Olsen, co-author with Michael Kitces of *The Advisor's Guide to Annuities*, *4th edition* (National Underwriter, 2014), agreed. "Trying to make a deferred annuity with a GLWB into a QLAC amounts to contorting it into something it isn't and shouldn't be," he said.

One argument against extending QLAC status to GLWB products is that they don't need relief from RMDs. GLWB products are liquid, so that the money that the contract owner needs to pay his or her RMDs each year is available. DIAs are illiquid, so all of the RMD had to come from the remaining tax-deferred assets or accounts.

In addition, the fair market value of a DIA rises during the deferral periods, raising the overall value of tax-deferred accounts and accelerating the distributions from the remaining tax-deferred assets. Finally, the amount of assets that can be put into a GLWB-protected VA or FIA is not limited. A QLAC FIA or VIA would presumably have to conform to QLAC limitations on premium size: $125,000 or 25% of retirement assets, whichever is less.

A different kind of complexity

On the question of complexity, it may be true that a DIA is simpler than an annuity with a GLWB rider. But GLWB products arguably present an easier purchasing decision for advisors and clients because they're not irrevocable and because contract owners have a lot of flexibility in how they use them to produce income.

Choosing a DIA provider can be difficult, not merely because of the risk of future insolvency but because at any given time price quotes range widely among insurers. A contract owner has to be careful not to buy a contract from an insurer in a month when the insurer isn't trying to be competitive. The spread between the highest and lowest monthly quotes can be as high as 10 percent.

Sometimes it's difficult to make apples-to-apples comparisons between products. "These products have individual nuances that require the financial professional to fully understand before determining the best use of such products," said Cloke in the LinkedIn discussion. When evaluating contracts and comparing quotes, it's essential to make sure that the contracts offer identical return-of-premium, death benefit and cash fund terms."

"Comparisons of products *must* either ensure that both products have identical benefits *or* that the difference in benefits is clearly revealed, so that the reader can better evaluate the difference in price," wrote Olsen.

A contract owner makes several commitments when purchasing a DIA. He or she needs to choose when to start income, and whether to protect beneficiaries with a return-of-premium death benefit before the income start date and/or with a cash-refund option. Changing these variables has a slider effect on the prices of the contracts, making them go up or down.

The difference in income between a life-only contract and a contract with a return-of-premium if the owner dies before the income start date may be as little as five percent or so if the owner starts income in his or her early 70s, according to actuary Noel Abkemeier, who participated in the LinkedIn discussion. But if the deferral period is 20 years and income doesn't start until age 85, for instance, the life-only contract may offer 40% more monthly income than the return-of-premium contract.

The exclusion of QLAC status from VAs and FIAs might be felt more painfully in the institutional retirement space than the retail space. Prudential and Great-West Life have been trying for years to encourage the use of a target-date-fund with a GLWB rider as an option in 401(k) plans. Their products did not get a boost from the creation of QLACs this year. But the door, as was pointed out, is not necessarily closed.