Six Ways to Dress Up QLACs

By Kerry Pechter *Wed, May 6, 2015*

RIJ spoke with annuity manufacturers and distributors about their strategies for selling qualified longevity annuity contracts, which are deferred income annuities for IRA money. The favorite, but not unanimous, strategy is to emphasize reductions in RMDs.

From the time he reached age 70½ until he died at 84, a retired auto executive (we'll call him Bill Clemens) deeply resented the IRS compulsion to take a distribution from his half-million dollar 401(k) plan each year.

Living easily on an executive-level pension and Social Security, with no mortgage or car payments, he and his wife didn't need the extra $20,000 or so in RMD income. They liked the accompanying bump up in annual income taxes even less.

If Bill had had access to a Qualified Longevity Annuity Contract, he would probably have leapt at the chance to cut his annual RMD by up to 25% for up to 15 years. Today, QLAC issuers and distributors are hoping that lots of retirees like Bill will do exactly that.

Last week, we wrote about the issuers of QLACs and some of the websites that promote these deferred income annuities. This week, we'll look at QLAC sales and marketing strategies that issuers and distributors intend to use.

So far, the most popular (but not the only) hook for selling QLACs is as a tool for postponing RMDs and taxes on up to $125,000 in qualified money until as late as age 85, especially for healthy people who don't rely on their RMDs for current income. But is the potential tax savings great enough to justify the loss of liquidity on an eighth of a million dollars for 15 years? Inquiring minds want to know.

A remedy for RMDs

Almost as soon as QLACs were announced by deputy Treasury Secretary Mark Iwry last July, advisors and manufacturers talked about marketing QLACs as a way to cut RMDs. They would appeal to America's Bill Luckabaughs, and spin the QLAC as a way to stop Uncle Sam from reaching so deeply into their pockets at age 70½.

Thrivent and Pacific Life, for instance, are two QLAC issuers who are stressing the RMD angle. Pacific Life's QLAC announcement led off with a headline about RMDs. At Thrivent, annuity vice president Wendy McCullough intends to lead with the RMD angle.

"We say, 'Look, if you have more required minimum distribution than you need in income, invest the difference in a QLAC. The QLAC is for people who do need their 401(k) for income but who don't need their entire RMD," McCullough told *RIJ* during a recent interview.

"Another thing we see happening: New retirees have more and more qualified than non-qualified assets," she added. "Up until now, they couldn't get longevity protection at later ages. It was never an option. With the QLAC, you'll reduce your tax bill and get longevity protection at the same time."

Six Ways to Sell QLACs

Purchasers of QLACs can:

- Postpone up to 25% of taxable RMDs to age 85
- Hedge against the cost of living to 100
- Budget for late-life medical expenses
- Make up for early Social Security claiming
- Enjoy a win-win: Longevity protection or legacy
- Take more risk with non-QLAC savings

One of the slides in a Pacific Life QLAC webinar this week showed an estimate of potential cumulative tax reduction of $41,409 from the purchase of a $125,000 maximum purchases of a QLAC of $41,409 between ages 70½ and 84, assuming an average annual growth rate of the IRA assets during that period of six percent. (Click on Pacific Life chart, below at left.)

The Pacific Life example assumed a 65-year-old man paying income tax at the rate of 30%. A retiree with a 30% tax rate has an annual pre-tax income north of $200,000, however. People with that kind of money may have more ambitious tax reduction strategies and probably have no fear of ever running out of money.

Not all manufacturers recommend leading with the RMD angle. One doubter is Dan Herr, vice president, Annuity Product Management, at Lincoln Financial, which has rolled out QLACs to the MGA (managing general agent) channel and is preparing to distribute them through its wholesaler, Lincoln Financial Distributors, and broker-dealer, Lincoln Financial Network.

Lead with longevity protection

"I struggle a little with the idea that the RMD deferral is the main reason you buy it," Herr told *RIJ*. "If I don't need that future income, if I'm just getting it out for the RMD exclusion, the benefit is fairly small. There's a large proportion of retirees who need assistance with lifetime income, and that's where our focus is going to be. That's where the real need for education is. I don't want to minimize the RMD. It's an added benefit. And there's a benefit in having clarity. But we're in the business of providing income guarantees.

"We'll position the QLAC the same way we positioned the DIA: as a tool to help clients and advisors address longevity income needs by deferring income up to age 85. It contains an element of tax deferral, but its main purpose should be to provide an efficient way to manage longevity risk. That's the heart and soul of what a longevity annuity should be," Herr said.

Indeed, the maximum annual tax savings is less than $1,000. The current limit on contributions to a QLAC is the greater of $125,000 or 25% of tax-deferred savings. By excluding that amount from the calculation of the RMD, a retiree would reduce his taxable distribution by about $4,900 according to current tables and his annual income tax bill by about $1,000.

Reduce Taxes

Dave saves ***$41,409*** *in taxes with QLAC.*

Age	QLAC Strategy $125,000 QLAC and $375,000 IRA at 6% Growth	Non-QLAC Strategy $500,000 IRA at 6% Growth	*Annual Tax Savings*
65-70	$0	$0	-
70½	$5,495	$7,326	$1,831
71	$5,815	$7,753	$1,938
72	$6,153	$8,204	$2,051
73	$6,511	$8,681	$2,170
74	$6,889	$9,185	$2,296
75	$7,288	$9,718	$2,430
76	$7,710	$10,281	$2,571
77	$8,118	$10,824	$2,706
78	$8,586	$11,449	$2,863
79	$9,035	$12,046	$3,011
80	$9,503	$12,671	$3,168
81	$9,993	$13,324	$3,331
82	$10,504	$14,005	$3,501
83	$11,036	$14,715	$3,679
84	$11,590	$15,453	$3,863

This hypothetical table compares the taxes of a QLAC strategy to that of a non-QLAC investment. For illustrative purposes only.

This raises questions about the logic of selling on the basis of RMD reduction. If high net worth clients can afford to give up access to $125,000 for up to 15 years, would they care about reducing taxes by $1,000 to $2,000 a year, especially if they are essentially just "kicking the can down road," as one Pacific Life presenter conceded in his webinar.

Conversely, if a $500,000 (or smaller) IRA represents someone's entire retirement savings, and he or she needs the entire RMD for current income, will that person be able to afford a QLAC? Not least, there's the question of whether the tax savings is worth the loss of $125,000 in potential liquidity and the potential growth on that amount.

"An advisor's best luck would be to lead with the tax piece. That's where we're headed with it," said Matt Carey, a Wharton MBA candidate and co-founder of Abaris, a DIA and (soon-to-be) QLAC sales site based in Philadelphia.

"But when you explain to people what it is, you find that [the tax savings] it's not that big a deal. I have a lot of clients—and speaking as a 'client' myself—it would be pretty nice to have a smaller RMD at age 70½. But the tax piece alone isn't enough. You've got to do both."

A 'bob and a lure'

"For those who can afford to buy the maximum QLAC, $125,000 is not that much money," said Sean Ruggiero, founder of an IMO in Coeur d'Alene, Idaho, as well as an educational website called Safemoneysmart. "Even some of the union workers out here are retiring with $1 million in retirement savings, or $1.3 million. We did a calculation, and the tax savings is not earthshaking. Especially when you consider the fact that you can't touch the money for 10 or 15 years."

But effective producers often need only the slimmest of conversation-starters in order to establish a relationship with a prospect, and Ruggiero thinks the QLAC's RMD aspect can easily do that. Producers can use it as a "bob and a lure" to attract attention and pave the way to the sale of another insurance product.

One advocate of that approach is Eric Estrada (aka "Thetaxfreeninja"), the marketing director of Synergy Annuity, an IMO in Houston. "You can earn more trust and bring in more assets by explaining that this is a smart tax move. Ninety percent of high net worth clients want the adviser to make recommendations about taxes, but only 10% do," he told *RIJ*.

"One producer and I wrote QLAC with 25% of the 401(k) and put the balance into a fixed indexed annuity. Then, because the client was healthy, we took the RMDs and bought a life insurance policy. The death benefit from the life insurance will recoup all the taxes and the distributions that were taken out. That was two annuity sales and maybe a life policy sale from one strategy."

But Estrada leads with the RMD angle. "We love the QLAC for RMD planning. It's hugely overlooked. We have a long history of working with advisors who partner with tax professionals, and the biggest complaint is around RMDs. RMDs tend to get overlooked," he said.

"Everyone is on the Social Security bandwagon, or talking about decumulation. That's the right thing to be doing. But we also have to talk about the money that's on the sidelines in qualified accounts. Clients typically have no idea what to do with it. And until now, they haven't had a solution for preserving it." Estrada and others pointed out that some retirees look at their IRAs as their legacy or "leave behind" money, and they resent RMDs for whittling away at it every year.

Asset retention strategy

One of drawbacks of QLACs for commission-paid agents and fee-based advisers involves compensation. The typical commission on a QLAC will be only about half the commission (3% vs. 6%) that a producer can earn selling an equivalent FIA. For a fee-based adviser, recommending a QLAC means "annuicide": a reduction of assets under management. If $125,000 leaves an investment portfolio and goes into a QLAC, a fee-based adviser charging one percent of assets loses $1,250 in annual revenue.

Carey believes he can show fee-based advisers that QLACs are a net gain for adviser and client. "We think fee-based advisors will eventually drive most of our sales," he told *RIJ*. The logic is that, if you have a client who is afraid of outliving his or her money, even if it means five or 10 or 15 percent less assets-under-management for you, this will help you establish credibility and trust with the client, and, in the long run, help you keep the rest of their assets."

More ways to position QLACs

Brainstorming sessions have produced other ideas for positioning QLACs. Although some people regard the QLAC's mandatory return-of-premium death benefit (a cash refund during the income stage is an option some issuers offer) as a necessary evil (it protects heirs but reduces the income payment), it can be a plus.

If you accept the premise that annuities sell best when positioned as win-win protection and not as a potential sunk cost, then QLACs with both death benefits and cash refunds might be the most appealing: If the client doesn't live long enough to get the income, his beneficiary gets a nice lump sum. The opportunity cost associated with loss of liquidity might be seen as a small price to pay for guaranteed higher consumption or a guaranteed legacy.

[One issuer noted that a QLAC without a cash refund during the income period makes no sense, because it creates an unacceptable scenario. Beneficiaries of a person who died a day before the income start date would receive the premium but beneficiaries of a someone who died a day after the income start date would receive nothing.)

QLACs may also be a hedge against the risk of rising out-of-pocket medical costs in old age.

"I've been approached by people in elder law who are interested in this as an alternative to long-term care insurance," Matt Carey told *RIJ*. "We're still in the early stages of thinking about DIAs and QLACs as alternatives to LTCI."

While "it would be really expensive to buy a longevity annuity to pay for nursing home costs," he noted, it would provide cash for any type of medical expense, including home health care. He also sees an opportunity, if and when partial annuitization becomes available, to market QLACs to people whose pensions have been terminated and paid out as lump sums.

"The good thing about it is that it provides cash [that you can use for any type of medical expense]" Carey added that when pensions are terminated and employees get offered a lump sum, if there's ever a provision for partial annuitization, that might present a window of opportunity to offer a QLAC.

Finally, a QLAC with a flexible start date could, like a DIA, serve to offset the loss of income for couples when one spouse dies and the survivor has to live on one Social Security payment. By the same token, either a QLAC or DIA could be positioned as a way for retirees who already taken the minimum Social Security benefit at age 62 to fix their mistake and "add back" the late-life income they forfeited by not waiting until age 67 or age 70 to claim.

In a perfect world, advisers and producers could recommend annuities based on their fundamental strengths—a guarantee of lifelong income and a mortality credit. But because so many affluent annuity prospects worry more about taxes than outliving their money (and because low interest rates don't compensate them for inflation risk and liquidity features dilute the mortality credit), the primary basis for marketing annuities will be tax deferral.