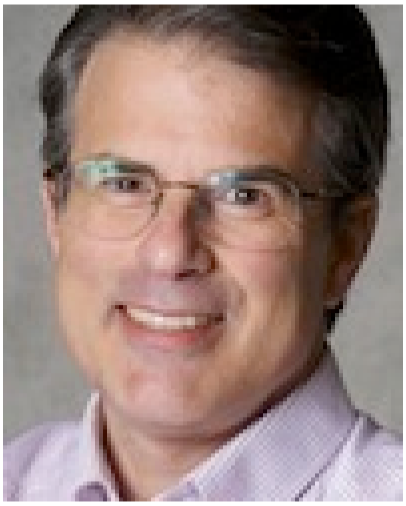
Tax-Free QLACs? It Makes Sense

By Kerry Pechter *Thu, Sep 14, 2017*

There would be no better way to jump-start awareness of longevity risk than by making withdrawals from qualified longevity annuity contracts tax-free. By reducing dependence on public assistance, the move could even pay for itself.



With tax reform soon to dominate our disquiet national discourse, I propose a modest change in the tax code with respect to qualified longevity annuity contracts, or QLACs. Income tax on withdrawals from QLACs should be eliminated. If so, QLACs would be the new Kardashians, in terms of media attention.

Most Americans don't know a QLAC from an Aflac. But retirement income mavens know that QLACs are deferred income annuities, purchased with up to 25% of a person's qualified savings (or $125,000, if less) to generate income starting after age 70½ but not later than age 85.

QLACs haven't had time to build much familiarity. The Treasury Department, in an effort led by deputy secretary Mark Iwry, introduced them in the second half of 2014. QLACs act as insurance against outliving your savings. Until you take income from a QLAC, you can exclude its value from your required minimum distribution (RMD) calculations.

For example, a person with $500,000 in a rollover IRA at age 65 could buy a QLAC with as much as $125,000. At age 70½, he or she would calculate their RMD on the basis of $375,000 instead of $500,000. The QLAC exclusion reduces the RMD and the income tax bill by 25%. When QLAC withdrawals begin, they're taxable as ordinary income.

QLACs are available if you know where to look. Vanguard investors can buy them at IncomeSolutions.com. Fidelity investors can buy them on Fidelity's annuity platform. You can buy them through immediateannuities.com. New York Life and Northwestern Mutual Life agents sell them.

So far, sales are low. But nothing would jump-start the deferred income annuity (DIA) market or make longevity risk a top-of-mind concern better than eliminating future income tax on QLACs. Perhaps only those payouts that begin at age 80 or later would be tax-free. That would encourage the intended use of DIAs: to provide income during the years when you are least likely to be alive (and when longevity insurance is cheapest).

Uncle Sam won't miss the tax revenue. The IRS, I've been told, doesn't even bother to count taxes paid on RMDs separately from other income taxes.

Deficit hawks are thinking: Whoa. Republicans and Democrats can't afford to play the Two-Santa game any longer, with Republicans handing out new tax cuts to wealthy voters and Democrats handing out new spending programs to struggling voters.

Perhaps we can find the money. Maybe 401(k) participants could check a box that says they'll take only 75% of the tax break on their contributions. They would pay for their untaxed QLAC withdrawals in advance. New research shows that, even in our instant-gratification culture, many people still like paying it forward.

Or perhaps we could assume that QLACs would pay for themselves by reducing the likelihood that people over age 80 will run out of money and need public assistance. (Alternately, QLACs might meet the conditions of a "Medicaid-friendly" annuity and be excludable from available assets. It may depend on which spouse wants to qualify for Medicaid. I'll check into that.)

Some might say that such a tax benefit would wasted on the many older Americans who aren't likely to pay much tax on their QLAC income anyway. In that case, it wouldn't cost much. But it would still raise awareness of QLACs.

Other countries have combined tax benefits with longevity risk protection. In Britain, before the annuitization mandates were repealed, the government sweetened annuity purchases by letting retirees spend 25% of their tax-deferred savings tax-free. Singapore, I believe, has experimented with a two-period retirement system, involving a period of systematic withdrawals followed by a period of annuitized income.

Longevity risk pooling—either with life insurance products or low-cost tontines (as Moshe Milevsky recommends)—is the most efficient societal response to the problem of financing unknown life expectancies. A tax break for QLACs would rivet the public's attention on longevity risk. Now's the time to ask for it.