FLEURUS INVESTMENT ADVISORY

May 25, 2016.

Qualified Longevity Annuity Contracts

Except for the very wealthy or the blissfully carefree among us, one of the greatest fears as we grow older is to outlive our money. Today, the average 65 year-old male is expected to live until 86. In the same vein, there is a 50% probability that one of the spouses in a married couple will reach the age of 92. With these numbers in mind, the prospect of living 20 to 30 years without earned income can be daunting. The Obama Administration is trying to alleviate this situation by promoting a new type of retirement savings vehicle known as a Qualified Longevity Annuity Contract (QLAC). While not without limitations, this investment vehicle offers a real measure of protection against longevity risk.

Background

Before getting into a description of what a QLAC is, it is important to remember the concept of Required Minimum Distributions (RMDs) that we discussed previously in our note "On IRAs" available at http://www.fleurus-ia.com/wp-content/uploads/On-IRAs.pdf.

RMDs are the minimum annual distributions that the IRS expects you to take from your IRAs, 401k and other qualified plans once in retirement. You can postpone taking those distributions until the year following the one when you reach 70 ½. Failure to do so exposes you to severe penalties of 50% of the minimum amount that should have been withdrawn and was not. RMDs are based on life expectancy tables.

What is a QLAC?

QLACs are longevity contracts that benefit from a favorable tax treatment. Their purpose is to provide a **guaranteed lifetime income**. In exchange for a given lump sum, the owner receives an income flow starting at some pre-determined date in the future. However, unlike the traditional annuities, **they have no cash value and therefore can pay significantly higher guaranteed income streams to their owners**. In addition, QLACs are qualified. This means that they benefit from a favorable treatment from the IRS in that they are excluded from the calculation of RMDs. More specifically, one can use an IRA or a 401k to buy a QLAC without triggering any immediate income tax liability. QLAC allow their owners to defer the payment of federal and state income taxes on that portion of their IRA that they use to buy the contract until the annuity stream starts, usually several years later. Only what is left on the IRA (post-QLAC lump sum) is used to calculate RMDs. The amount that can be invested in a QLAC (the lump sum) is the lower of $125,000 or 25% of the value of your IRA. For a married couple, that amount can be doubled. Other details of importance: 1) The QLAC can be written at any age before 85, 2) the sooner it is written, the higher the annuity payment will be, 3) Annuity payments must start, at the latest, at age 85.

Below is an example that illustrates the main attributes of a QLAC. The numbers that are used are derived from a recent and real situation.

Assume a 58 year old man has a $500,000 IRA and wants to buy a QLAC that starts making monthly payments to him when he reaches the age of 80 and not before. He goes to one of the dozen insurance companies that provide those products and is told that a $125,000 lump sum in 2016 will allow him to receive the monthly equivalent of $35,000 of yearly income starting in year 2038, when he turns 80. This annual payment of $35,000 is significantly higher than the annuity he could expect to receive from a traditional annuity product. This is because the QLAC has no cash value. The lump sum payment at the onset of the contract is used only to generate the income stream of later years and not has an accumulation (investment/savings) product. This in return allows the insurance company to pay a significantly higher annuity.

That $35,000 is guaranteed until death and can be adjusted for inflation, at a cost. Income taxes on the $125,000 of IRA money used to buy the QLAC are postponed until year 2038 when they are taken from the $35,000 annual income stream. If the QLAC owner dies before he starts receiving the annuity stream, his beneficiary receives the $125,000, unadjusted for earnings. If he dies at age 82, two years after the first payment has been made, the contract can be written so that his heirs will receive the equivalent of $125,000 minus the value of the annuity payments already made. The contract can be written as a single annuity or as a joint annuity. If a joint annuity is chosen, the annual stream will be reduced when compared to a single annuity but the contract will remain in force for the benefit of the surviving beneficiary. In this case the $35,000 annual payment would be made until the second spouse dies.

To use an analogy, the QLAC is to annuities what the Term Life Insurance is to the Whole Life Insurance. It allows you to buy pure protection against longevity risk the way term life insurance allows you to buy "pure" benefit insurance. It cannot be used as a savings/investment account (traditional annuities and whole life insurance) and therefore pays a much higher annual benefit, once you reach the trigger year (2038 in our example).

The two significant advantages of this product are: 1) Guaranteed lifetime income starting at a certain age, 2) Deferral of income taxes until the first annuity payment is received. The main drawback of the product is that the retiree who has a QLAC must live on a reduced potential income until he reaches the time when the annuity stream starts.

Concluding remarks

A good friend of mine recently told me that he had bought a QLAC. Since he happens to be a highly regarded and well-known researcher in the asset management world and one who is particularly knowledgeable about retirement issues, I thought a note on this subject was warranted. I hope you have found it helpful. Please feel free to contact me should you wish to obtain further clarifications on this important investment retirement product.

Finally, Fleurus Investment Advisory, LLC derives no benefit, direct or indirect, from the promotion of QLACs or any other investment products. We share this information with you because we think that you may benefit from it.

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