VIA ELECTRONIC DELIVERY

May 16, 2016

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2016-26)
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Recommendations for QLAC Guidance on 2016-2017 Priority Guidance Plan

To whom it may concern:

We are writing on behalf of the undersigned organizations to recommend two items for inclusion on the 2016-2017 Priority Guidance Plan.[1] Both items relate to qualifying longevity annuity contracts ("QLACs"), as defined in the regulations under section 401(a)(9).[2] In particular, guidance is needed to:

(1) Clarify how the limitations on QLAC premiums apply when a participant in a qualified plan wants to purchase a QLAC *via* a direct rollover because the plan does not offer one, and

(2) Clarify how the regulations apply following a divorce of the QLAC owner if the contract was originally purchased with spousal benefits.

Guidance on these items would resolve significant issues that are preventing many taxpayers from gaining access to QLACs. We are very strong supporters of the existing QLAC guidance as a creative and innovative means to enhance the market for lifetime income. As we all know, the need for lifetime income is increasing as Americans live longer and the retirement world continues its shift from defined benefit plans to defined contribution plans and IRAs. We believe that the two suggested clarifications identified in this letter would make a very material difference with respect to access to QLACs and thus serve the national need for greater access to lifetime income.

The requested clarifications could be provided through IRS guidance, without the need to amend the regulations and without increasing administrative burdens for the IRS or taxpayers. The specifics of our request are set forth below.

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[1] The Treasury Department and Internal Revenue Service ("IRS") invited the public to recommend items for the 2016-2017 Priority Guidance Plan in Notice 2016-26, 2016-14 I.R.B. 533.

[2] *See* Treas. Reg. section 1.401(a)(9)-6, Q&A-17. Unless otherwise indicated, "section" means a section of the Internal Revenue Code of 1986, as amended.

(1) Background

In 2014, the Treasury Department and IRS published final regulations on QLACs under section 401(a)(9).[3] QLACs are a form of longevity insurance that can help retirees hedge the risk of outliving their savings in defined contribution (DC) plans and IRAs. The regulations eliminated an impediment to longevity insurance under the section 401(a)(9) minimum distribution rules, as part of a broader effort by the Treasury Department and IRS to facilitate greater access to lifetime income options in DC plans and IRAs.[4]

The regulations include a series of definitional requirements for QLACs.[5] Those requirements generally are intended to ensure that QLACs remain consistent with the purpose of section 401(a)(9), which is to limit tax deferral so that tax-qualified retirement savings are used primarily for retirement purposes. The QLAC requirements achieve this goal, but inadvertent interpretive uncertainties exist and are making it difficult, in certain seemingly unintended ways, to access QLACs. We think these uncertainties can be addressed through IRS guidance, consistently with section 401(a)(9) and without having to amend the regulations and without any additional technological or other burdens on the IRS.

(2) Clarifying the QLAC Premium Limits to Facilitate Purchases *via* Rollover

(a) Background

The QLAC regulations limit the premiums an individual can pay for a QLAC to the lesser of (1) $125,000 and (2) 25% of the individual's account balance under the plan or IRA.[6] The $125,000 limit applies across all types of arrangements, whereas the 25% limit applies separately to each DC plan and collectively to all IRAs that an individual owns.[7] For purposes of the 25% limit, the account balance of a DC plan is determined as of the most recent valuation date and is adjusted up or down to reflect subsequent contributions or distributions.[8] In contrast, the account balance of an IRA is determined as of December 31st of the previous calendar year, and there is no specific mention of any adjustment for subsequent contributions or distributions.[9]

(b) The Problem

It is rare for a DC plan to offer a QLAC option directly. As a result, the only way for virtually any DC plan participant to obtain a QLAC is by rolling money out of the plan to an IRA. QLACs are readily available in the IRA market. Typically, a QLAC is issued as a contract that also qualifies as an individual retirement annuity under section 408(b) (an "IRA annuity").

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[3] T.D. 9673, 2014-30 I.R.B. 212.

[4] *See* Dep't of the Treasury and Dep't of Labor, *Request for Information on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans*, 75 Fed. Reg. 5253 (Feb. 2, 2010).

[5] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(a).

[6] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(a)(1) and (b).

[7] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(b); Treas. Reg. section 1.408-8, Q&A-12(b)(3).

[8] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(d)(1)(iii).

[9] Treas. Reg. section 1.408-8, Q&A-12(b)(3)(i).

This obviates the need for the QLAC to be held within an individual retirement account under section 408(a).

When a QLAC is purchased in such a direct rollover transaction, it is not clear whether the regulations limit the purchase to 25% of the individual's account balance in the plan or 25% of the account balance in the individual's IRAs. If it is the latter, significant leakage from the plan could occur and the QLAC purchase could be unnecessarily complicated and delayed. These problems are illustrated in the following example:

> Assume that an individual has a $500,000 account balance in her former employer's DC plan. She wants to use 10% of that balance, or $50,000, to purchase a QLAC, but her plan does not offer one. She decides to roll the money from the plan to purchase a QLAC that also qualifies as an IRA annuity. However, she currently does not own any IRAs. If the 25% limit on QLAC premiums applies based on her IRA account balance (which is zero), she will need to roll *$200,000* from her plan just to facilitate the $50,000 QLAC purchase. Moreover, because the regulations measure her IRA account balance as of the prior year-end (which, again, was zero), she will need to roll the $200,000 from the plan to an IRA, wait until the next year, then transfer $50,000 from the IRA to a QLAC that qualifies as an IRA annuity. After the transaction, the individual would own a QLAC that clearly complies with the intent of the premium limits, but would have unnecessarily moved $150,000 from her plan to an IRA.

As noted below, we ask that you clarify that in the case of a direct rollover, the 25% limit applies based on the plan balance, not the IRA balance. That would make the above transaction far simpler and more efficient, as the individual could simply directly roll over $50,000 to a QLAC that qualifies as an IRA annuity. As this example shows, applying the 25% limit based on the IRA account balance would make it much more complicated to purchase a QLAC and would result in unnecessary outflows from the plan.

Someone could argue that, if the 25% limit applies to the IRA balance, as illustrated above, the individual in the above example could theoretically keep the $150,000 in the plan by rolling it back to the plan after the QLAC purchase. In actuality, however, most plans would not allow this amount to be rolled back into the plan. Even if a plan allowed such a return rollover, it would merely illustrate the lack of justification for an interpretation that required all of these steps in the first place – the individual would end up in the same posture as if the 25% limit had applied based on her account balance in the plan, except for the delay and the significantly greater transaction costs to the individual caused by having to complete all the unnecessary additional steps.

Unfortunately, the market is generally interpreting the regulation conservatively and is applying the cumbersome approach described in the example above. This in turn is having a significantly adverse effect on the ability of individuals to protect themselves against longevity risk through the purchase of a QLAC.

(c) The Solution

As noted, the solution to this problem would be for IRS guidance to clarify that the 25% limit applies based on the account balance in the plan in the following circumstances. The guidance could describe a situation like the one in the example above, involving a direct rollover from a plan to an IRA for the specific purpose of purchasing a QLAC. The guidance would then clarify that in such a situation the 25% limit is applied based on the account balance in the plan as of the most recent valuation date occurring immediately before the rollover, not the prior year-end account balance in the IRA. This would merely clarify which of two existing rules in the regulations applies to the transaction. Moreover, in the direct rollover context where the distribution is used to directly purchase a QLAC, treating the distribution as coming from the plan for purposes of the 25% limit is entirely consistent with the structure of the section 401(a)(9) regulations, which state that in the context of a rollover, "the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover."[10]

Thus, the regulations would not need to be amended. In addition, the transaction would be reported on existing IRS forms without the need for the IRS to make any amendments to those forms.[11]

(3) Clarifying How QLACs with Spousal Benefits Are Treated Following Divorce

(a) Background

The QLAC regulations prescribe very different rules depending upon whether the owner's beneficiary is his or her spouse. If the sole beneficiary is the QLAC owner's spouse, the contract can provide *both* a lump sum return of premium death benefit *and* a 100% survivor annuity.[12] However, if the sole beneficiary is not the QLAC owner's spouse, the contract can provide *either* a lump sum return of premium death benefit *or* a survivor annuity (but not both), and a non-spouse survivor annuity is subject to a required reduction in the annuity payments after the owner's death.[13]

(b) The Problem

The regulations do not address how the QLAC death benefit rules apply if the beneficiary is the owner's spouse on the date the contract is issued, but because of a subsequent divorce is no longer the owner's spouse when the annuity payments commence or when the owner dies.[14] If a

[10] Treas. Reg. section 1.401(a)(9)-7 Q&A-1.

[11] Specifically, the applicable IRS forms would be Form 1099-R (reporting the direct rollover), Form 5498 (reporting the contribution to the IRA annuity that qualifies as a QLAC), and Form 1098-Q (reporting the premiums and other information regarding the QLAC).

[12] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(c)(1).

[13] Treas. Reg. section 1.401(a)(9)-6, Q&A-17(c)(2).

[14] *Compare* Treas. Reg. section 1.401(a)(9)-6, Q&A-2(b) (spousal status is determined "as of the annuity starting date for annuity payments") and Treas. Reg. section 1.401(a)(9)-5, Q&A-4(c)(2) (spousal status for individual accounts is re-determined on January 1st of each year).

beneficiary's status as a spouse or non-spouse is determined after a QLAC is issued, *e.g.*, on the date annuity payments commence, a contract that was issued with permissible benefits might be viewed as providing impermissible benefits merely because of the divorce.

If a contract that is intended to be a QLAC provides impermissible benefits, severely adverse tax consequences could arise for the participant.[15] To prevent a divorce from triggering those adverse consequences, in theory the QLAC issuer could modify the contract's benefits after the divorce, but this may be difficult or impossible. The price and benefits can differ materially based on whether the spouse or non-spouse rules apply, and insurers need to know which rules will apply so they can price the product at issuance and so the purchaser will know what they are getting for what price. To avoid these problems and uncertainties, some insurers have decided to just offer single life QLACs, which deprives spouses of important benefits.

(c) The Solution

The solution to this problem would be for IRS guidance to clarify that a divorce occurring after a QLAC is purchased but before payments commence will not affect the permissibility of the joint and survivor benefits previously purchased under the contract if a qualified domestic relations order ("QDRO") (in the case of a retirement plan) or a divorce or separation instrument (in the case of an IRA) provides that the former spouse is entitled to the promised spousal benefits under the QLAC. Such a clarification would be consistent with a general rule that already exists in the section 401(a)(9) regulations, which provides that a former spouse is treated as a spouse for purposes of the minimum distribution requirements if certain requirements are met. That rule states:

> A former spouse to whom all or a portion of the employee's benefit is payable pursuant to a QDRO will be treated as a spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9), including the minimum distribution incidental benefit requirement, regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of sections 401(a)(11) and 417.[16]

It appears, though not clearly, that this general rule applies to QLACs, but in light of the repercussions of being wrong on this point, the market appears to have generally taken a conservative position on the application of the rule to QLACs, which makes selling QLACs in the plan context very difficult. Accordingly, it is very important that there is confirmation that the above quoted general rule applies to QLACs in the plan context.

In addition, although QDROs are a concept applicable to employer-sponsored plans and not IRAs, a parallel concept should apply to IRAs, but obviously without regard to the technical requirements that apply to QDROs. Applying a parallel concept to IRAs is supported by the

[15] Specifically, the value of the contract would be included in the account balance that is used to determine the owner's required minimum distributions under section 401(a)(9). This, in turn, could subject the owner to a 50% excise tax under section 4974.

[16] Treas. Reg. section 1.401(a)(9)-8, Q&A-6(a).

existing regulatory provision that, except as otherwise provided, all of the section 401(a)(9) rules for plans apply to IRAs.[17] As a result, clarification that such a parallel concept regarding former spouses applies for purposes of QLACs issued in the IRA market would be both appropriate and very helpful in addressing an uncertainty that has inhibited the QLAC/IRA market. Such a clarification could provide that "divorce or separation instruments"[18] can cause a former spouse to be treated as the spouse for minimum distribution purposes, including QLACs, in the same manner as a QDRO.

For IRAs, spousal rights may continue after a divorce in two distinct ways. First, a former spouse may have rights under the contract which remain pursuant to a divorce or separation instrument. Second, the former spouse may be contractually entitled to benefits originally purchased under the contract which remain unchanged after a divorce or separation. In the latter case, the parties may not think they need to specify in the divorce or separation agreement that the former spouse will continue to be the beneficiary of the QLAC upon the owner's death. For this reason, the guidance would have an even broader and more appropriate effect if it could also clarify that, even in the absence of a formal divorce or separation instrument that addresses the contract, a former spouse is treated as the spouse for purposes of the QLAC requirements as long as the former spouse remains contractually entitled to the benefits originally purchased under the contract following the divorce.

These clarifications would ensure that former spouses can be protected both in plans and IRAs. Moreover, because these clarifications are consistent with the existing regulations and would merely explain how those regulations apply to QLACs, the clarifications could be provided through IRS guidance without having to amend the regulations.

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We appreciate the opportunity to provide recommendations for the Priority Guidance Plan. We believe the guidance we have requested would resolve significant issues relevant to many taxpayers and would promote sound tax administration by facilitating the access to QLACs that the Treasury Department contemplated when promulgating the regulations. In addition, because the guidance would merely clarify how existing rules apply to specific situations, the guidance could be drafted in a manner that would be easy for taxpayers to understand and apply, as well as for the IRS to administer on a uniform basis without significant additional burdens. We would be happy to discuss our request with you further if you would find it helpful.

Sincerely,

[17] *See* Treas. Reg. section 1.408-8, Q&A-1

[18] This term would have the meaning set forth in section 71(b)(2).

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Committee of Annuity Insurers	Committee on Investment of Employee Benefit Assets
Insured Retirement Institute	Morningstar, Inc.
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