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A new era for longevity insurance

Treasury rule makes it advantageous to purchase these contracts within a retirement account

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Longevity insurance refers to a forward-starting life annuity. As an example, an investor at age 60 plunks down a wad of cash with an insurance company that promises a monthly income for life; but this monthly income only starts when the investor reaches 85. In its simplest form, if the investor does not reach 85, there are no payments. The idea is that if the investor runs out of money by living “too long,” this longevity insurance will kick in.

The government thinks that longevity insurance contracts are a good thing for current and future retirees and is encouraging their purchase by granting longevity insurance contracts special benefits. If an investor is going to buy a longevity insurance contract, it has recently become advantageous to buy the contract in one's retirement account rather than owning it outright in their own name.

“As boomers approach retirement and life expectancies increase, longevity income annuities can be an important option to help Americans plan for retirement and ensure they have a regular stream of income for as long as they can live,” said J. Mark Iwry, the Treasury Department's deputy assistant secretary for retirement and health policy.

The Treasury ruling clears the way for participants in IRAs, 401(k)s, qualified defined-contribution plans, 403(b)s, as well as eligible governmental 457 plans — but not Roth IRAs or defined-benefit plans — to purchase longevity insurance within the retirement account.

Since 2010, there has been a movement to allow these investments in IRAs and the like. The biggest problem was how these contracts would work when the retiree hit 701/2 and needed to start to make required minimum distributions. What value could be placed on a contract that could just evaporate at death; if all the money was in these contracts, where would the money come from to make the RMDs?

The government's solution: amounts invested in longevity annuities will count as having zero value for purposes of calculating RMDs. Thus an investor will decrease the amount of RMDs that will need to be distributed out and taxed.

Let's take an investor with $500,000 in his or her IRA and $1 million in a taxable account. The investor is planning on buying a longevity annuity for $100,000. If the investment is made in the IRA, RMDs will only be needed by calculation off of a base value of $400,000. However, if the longevity insurance was bought in the taxable account, the investor would have to make RMDs based on $500,000 to stay within the rules.

To make sure that the retirement plans do not go overboard buying annuities, there is a limit of how much can be invested. Your retirement accounts cannot have more than $125,000 in such annuities nor can they make up more than 25% of your retirement accounts. The first proposed regulations issued in 2012 had a $100,000 limit. Comments convinced the government to raise the limit to $125,000. These amounts can be raised over time for inflation.

To ensure that the longevity annuities resemble the investment the government envisioned, the contracts must start to pay by age 85. Earlier is OK; 85 is just the latest date when payments must start to flow. The regulations also allow that a later age can be specified in the rules if changes in mortality rates dictate.

The original proposals only allowed the simple longevity contract already described: make it to the start date or you get nothing. Such a deal scared many investors off.

Insurers commented that investors more often bought a version that at least guaranteed a return of principal should the insured die before getting back their money. Of course, these contracts pay out much less than a contract without this feature. Nevertheless, insurers convinced the government to not only include this type of annuity but also allowed it to be valued at zero although it clearly has some value under any circumstances. The contract cannot be variable or indexed.

A further advantage can be reaped by those who would have been caught in the “inherited IRA tax spiral.” These beneficiaries can net as little as 32 cents of every dollar left in an IRA. If the hypothetical investor above died before 85 there would be $100,000 less in the inherited IRA to be so heavily taxed.

Bottom line: if your clients are going to buy longevity insurance, have them buy it in their retirement plan; it is the most optimum location for the investment.

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