American Academy of Actuaries
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August 11, 2017

Honorable Devin Nunes
1013 Longworth HOB
Washington, DC 20515

Dear Rep. Nunes:

On behalf of the Pension Committee of the American Academy of Actuaries,[1] we write to encourage Congress to include in its work plan a continued examination of proposals made in The Retirement Security Needs Lifetime Pay Act of 2009.[2]

Failure to set aside adequate resources is a common problem in retirement planning—particularly for those who survive beyond their life expectancies. We support efforts to help ensure adequate retirement security by providing incentives for retirees to choose annuities, which provide them with guaranteed income for life. As part of the tax incentives for individuals to choose annuities, we have two suggestions:

1. All money from qualified plans should be treated equally—specifically, the tax incentive for annuities purchased from defined contribution plans and IRAs should be extended to also include defined benefit plans; and
2. The cap on the tax incentive should be the same for both qualified and nonqualified annuities.

Concern for Defined Benefit Plan Annuities

We believe that qualified defined benefit plans (including annuities purchased by these plans) should be treated no less favorably from a tax perspective than other tax-qualified sources of retirement income. The Retirement Security Needs Lifetime Pay Act would exclude from income a portion of annuity payments received from individual retirement accounts (IRAs) and other similar retirement plans, but does not extend this special treatment to annuities from defined benefit plans. This creates an incentive for participants whose defined benefit plan provides a lump sum to take that amount and purchase an annuity from an insurance company. This outcome might be inefficient and expensive (as it might reduce the ultimate annuity amount

[1] The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] H.R. 2748 introduced in the 111th Congress.

when converting an annuity to a lump sum and back into an annuity outside of the plan), and might create different risks for the individual.[3]

Having an incentive for annuity payments from defined benefit plans is good public policy. Typically, the amount of the annuity benefit is higher than could be purchased in the market by the equivalent cash payment from the defined benefit plan. Providing this tax incentive only outside of defined benefit plans makes these plans less attractive and potentially detracts from overall retirement security. Such an inequitable tax structure also could simply give participants more reason to elect an annuity option over the lump sum option within their plan. Giving a greater tax advantage to annuities purchased outside a defined benefit plan than to those paid directly from a defined benefit plan will encourage participants who want lifetime income to elect a lump sum with the intention to annuitize some or all of the benefit outside the plan. The annuity available outside of the plan will typically be less favorable than what the plan would have paid before considering the tax incentive and may even be less favorable after the incentive is applied. Making it tax-advantageous to take a lump sum should not be a desired result.

Concern Regarding Lower Maximum Dollar Exclusion for Qualified Plans

While we believe any legislation on this issue should cover all qualified plans, it would be reasonable to exclude from income a lower percentage of taxable payments made from a tax-qualified plan (defined benefit, defined contribution, or IRA) than from a nonqualified annuity purchase. This makes sense because the qualified payment—paid for with pretax dollars—is fully taxable, while the nonqualified payment—paid for with after-tax dollars—is already partially excluded from taxation due to the basis recovery rules in Internal Revenue Code (IRC) §72.

Section 2(a) of the Retirement Security Needs Lifetime Pay Act of 2009 proposed both a percentage cap and a dollar cap on the exclusion from income. The proposed percentage exclusion for the qualified plan (25 percent of the full amount) would generally be comparable to, if not larger than, the proposed exclusion for the nonqualified annuity (50 percent of the taxable portion), before reflecting the dollar cap. However, we believe that the maximum dollar exclusion should be the same for qualified and nonqualified plans—e.g., at the $10,000 level in the proposal for nonqualified annuities.

While the 25 percent / 50 percent differential achieves some rough comparability between the two types of annuities at lower benefit levels, the higher dollar exclusion limit for nonqualified payments winds up being far more valuable for nonqualified annuities than for comparable qualified annuities when the payments are large. The attached example illustrates this point by comparing the effect of this proposal on annuities purchased though a tax-qualified plan to the effect on annuities purchased with after-tax dollars,[4] based on initial investments of $200,000, $400,000 and $700,000.

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[3] For example, PBGC coverage, with its limitations, compared to life insurance insolvency protection through the Life and Health Guaranty Associations, with their limitations.

[4] For the sake of demonstration of concept, identical assumptions were used for in-plan and out-of-plan calculations. We acknowledge annuity purchase rates may not be the same for annuities offered through an employer plan and those available in the individual insurance market place. Differences would include use of unisex rates in employer sponsored plans (vs. sex-distinct for pricing individual annuities) as well as differences in expense charges. In addition, it takes more to save a given amount of money in after-tax dollars than before-tax dollars. Finally, someone with $200,000 saved is likely to be in a lower tax bracket than someone with $700,000 saved.

- For the $200,000 investment, the increase in the after-tax annual payment from each type of plan is roughly comparable.
- For the $400,000 and $700,000 investments, the increase in the after-tax annual payment is much more significant for the nonqualified annuity than for the qualified annuity.

We have also included in the example the effect on a qualified annuity if the maximum dollar exclusion was raised from $5,000 to the nonqualified annuity limit of $10,000. This shows that the increased limit brings more balance between qualified annuities and nonqualified annuities.

Conclusion

There are various ways of saving for retirement. Defined benefit plans, defined contribution plans, annuity products, and regular savings in fixed yield and equity investments are options, but the defined benefit system represents a crucial and highly effective method of providing retirement income security to millions of people across the country. Favorable tax treatment for lifetime income (annuities and qualified pension benefits) has encouraged individuals and employers to consider these options, which we believe are beneficial to a society as a whole as they reduce the likelihood of an individual outliving their savings. When Congress reduced the tax rates for capital gains and dividends, it allowed investments outside of qualified plans to compete more effectively from a tax perspective with annuities and pensions. This makes annuities and pensions relatively less attractive to participants and removes an incentive for employers to sponsor defined benefit plans. We support efforts to adjust tax incentives to allow annuities and pensions to compete more effectively with other investment options.

The proposals in the Retirement Security Needs Lifetime Pay Act of 2009 could help balance the incentives for retirement savings delivered through nonqualified annuities and defined contribution plans. However, excluding defined benefit plans from the special tax treatment afforded these other retirement income vehicles places defined benefit plans at a disadvantage. We hope Congress will rectify this situation. Any proposal to ensure adequate retirement security should seek to make defined benefit plans more attractive to employers and participants, rather than decreasing their efficiency at providing retirement income to participants.

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We would be happy to meet with you to discuss our concerns as well as other issues related to this proposal, such as the treatment of annuities already in pay status when this provision is enacted and the effect of this proposal on Roth IRAs and Roth 401(k)s. Please contact Monica Konaté, pension policy analyst (202-223- 8196, Konaté@actuary.org), if you have any questions or would like to discuss these items further.

Sincerely,

Ellen L. Kleinstuber, MAAA, FSA, FCA, FSPA, EA
Chairperson, Pension Committee
American Academy of Actuaries

Example Assumptions

a.	Tax rate	35%	35%	35%
b.	Age	65	65	65
c.	Annuity premium per $1 of annual payment	$ 12.00	$ 12.00	$ 12.00

Annuity purchased in 401(k) /IRA with a $5,000 limit

d.	Lump sum in 401(k)	$ 200,000	$ 400,000	$ 700,000
e.	Annuity (fully taxable) = d. / c.	16,667	33,333	58,333
f.	After-tax (current) = e. x (1 - a.)	10,833	21,667	37,917
g.	Exclusion from tax (proposed) = lesser of 25% of e. or $5,000	4,167	5,000	5,000
h.	After-tax (proposed) = g. + (e. - g.) x (1 - a.)	12,292	23,417	39,667
i.	Increase in after-tax annuity = h. -f.	1,458	1,750	1,750
i.	Increase as a percentage of gross annuity = i. / e.	8.8%	5.3%	3.0%

Annuity purchased with after-tax dollars

k.	After-tax Savings	$ 200,000	$ 400,000	$ 700,000
l.	Annuity (partially taxable) = k. / c.	16,667	33,333	58,333
m.	IRS life expectancy	20.0	20.0	20.0
n.	Exclusion ratio = k. / (l. x m.)	60.00%	60.00%	60.00%
o.	Exclusion (current) = l. x n.	10,000	20,000	35,000
p.	After-tax (current) = o. + (l. - o.) x (1 - a.)	14,333	28,667	50,167
q.	Exclusion from tax (proposed) = lesser of 50% of (l. - o.) or $10,000	3,333	6,667	10,000
r.	After-tax (proposed) = o. + q. + (l. - o. - q.) x (1 - a.)	15,500	31,000	53,667
s.	Increase in after-tax annuity = r. - p.	1,167	2,333	3,500
t.	Increase as a percentage of gross annuity = s. / l.	7.0%	7.0%	6.0%

Annuity purchased in 401(k) /IRA with a $10,000 limit

u.	Lump sum in 401(k)	$ 200,000	$ 400,000	$ 700,000
v.	Annuity (fully taxable) = u. / c.	16,667	33,333	58,333
w.	After-tax (current) = v. x (1 - a.)	10,833	21,667	37,917
x.	Exclusion from tax (proposed) = lesser of 25% of v. or $10,000	4,167	8,333	10,000
y.	After-tax (proposed) = x. + (v. - x.) x (1 - a.)	12,292	24,583	41,417
z.	Increase in after-tax annuity = y. - w.	1,458	2,917	3,500
aa.	Increase as a percentage of gross annuity = z./v.	8.8%	8.8%	6.0%

We have used the same tax rate in all three rows. If we used a 15% tax rate in the $200,000 examples, the values in rows j., t., and aa. (8.8%, 7.0%, and 8.8%) would become 3.8%, 3.0%, and 3.8%.