May 3, 2012

CC:PA:LPD:PR (Reg-115809-11)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington DC 20044

RE: Longevity Annuity Contracts

To Whom It May Concern:

The American Academy of Actuaries[1] Pension Committee respectfully requests your consideration of its comments and recommendations with respect to the proposed regulations for longevity annuity contracts[2] (REG-115809-11). The committee commends the Department of the Treasury and the Internal Revenue Service (IRS) for this much-needed step to help provide financial security for American workers throughout their retirement years. Retirees face serious challenges in dealing with the many risks associated with retirement. Longevity risk is particularly difficult for an individual to manage without the help of the pooling available through some financial products. The existing regulations governing minimum distributions made it difficult for retirees to use tax-sheltered funds for these products.

The proposed regulations would allow individuals to use retirement funds to provide significant protection from longevity risk. These proposals will greatly improve upon current regulations. We respectfully submit that the regulations could be enhanced further with the modest changes suggested in this letter. Thank you for the opportunity to provide these comments.

Percentage Limitation for Past Purchases

Under the proposed regulation, the amount allowed to purchase longevity insurance (lesser of $100,000 or 25 percent of the account) would be offset for past premium payments. Applying a dollar-for-dollar offset to the $100,000 limit is appropriate, but applying that same offset to the percentage limit could be problematic. The adjustment seems to assume that the account would include the value of the previously purchased qualifying longevity annuity contracts (QLACs). But the QLAC, as defined, would not have a surrender value and also the market value of the contract might be difficult to define and may not be available in a timely manner from the provider.

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists 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] Proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3), 408A(c)(5), and 6047(d) of the Code

Consider the following hypothetical example:

A participant with an account balance of $120,000 would be permitted to apply $30,000 toward the purchase of longevity insurance. If the participant instead elects to apply $20,000 to the purchase of longevity insurance, one might expect that the additional $10,000 could be purchased at a later date. Although the non-QLAC assets in the account still might be valued at $100,000, the market value of the QLAC could be difficult to determine or unavailable at the time of a second purchase. This may make determining the 25 percent limitation problematic.

There are two potential solutions to this dilemma. The amount of the prior purchase could be added back to the account balance (excluding the value of the QLAC) before taking 25 percent and then offsetting by prior purchases (($100,000 + $20,000) x .25 - $20,000 = $10,000). As an alternative, the 25 percent limitation could be applied to the value of the account excluding the previously purchased QLAC and then offset by 75 percent of previous purchases ($100,000 x .25 – 20,000 x .75 = $10,000)

Either of these approaches would avoid the problem of determining the market value of the previously purchased QLAC. The second approach would be easier to implement in the regulations as currently drafted by changing A-17 (b)(3)(i) to read "25 percent of the employee's account balance under the plan determined on that date, excluding the value of any previously purchased QLAC, over" and A-17(b)(3)(ii) to read "75 percent of the sum of—." We suggest a similar change would be appropriate for individual retirement accounts (IRAs).

25 Percent Contribution Safe Harbor

It is a reasonable assumption to expect that some providers will develop "QLAC investment options" that would allow participants to direct their periodic contributions to the purchase of a QLAC. This option would enable participants to buy the QLAC over a period of time, thus averaging the cost, and mitigating the risk of a large purchase at a high-cost time.

In the interest of simplification, the committee recommends a safe harbor permitting up to 25 percent of all contributions to the account (subject to the $100,000 limit) to be directed to a QLAC investment option. This would allow a participant systematically to allocate a quarter of all deferrals to a QLAC without having to worry that poor investment returns might lower the account balance and cause the accumulated QLAC deferrals unexpectedly to exceed the 25 percent limit.

Defined Benefit Plans as Provider of QLACs

Many individuals currently participate in both a defined benefit plan and a defined contribution plan offered by the same employer. A participant in both plans might reasonably conclude that his or her longevity protection from the defined benefit plan is insufficient. This participant could use 25 percent of the account balance in the defined contribution plan (but not more than $100,000) to purchase a QLAC.

The proposed regulation requires that the annuity contract be issued by an insurance company. This requirement seems too restrictive and should be expanded to include a defined benefit plan offered by the same plan sponsor as the defined contribution plan. We would suggest this expansion be made available for 401(a), 403(b), and 457(b) plans, but not for an IRA.

The plan sponsor may be willing to provide the QLAC through the defined benefit plan. This offers several advantages to the participant:

- The employer is typically a known, trusted source.
- The participant already is entitled to an annuity from the defined benefit plan, thus providing potentially one source for all payments.
- The pricing of the QLAC by the plan sponsor might be more attractive than that offered by insurance companies for some or all participants.

For plan sponsors willing to offer this type of annuity to employees through a rollover otherwise consistent with IRS Revenue Ruling 2012-4, we see no policy reason for prohibiting provision of such an annuity from a defined benefit plan. We note that this suggestion likely would require modification of the proposed regulations and Revenue Ruling 2012-4.

Many defined benefit plans offer full or partial lump sum distributions. A participant may wish to elect a lump sum distribution but purchase a QLAC to provide longevity protection. Under the proposed regulations, the participant could accomplish this by rolling the lump sum into an IRA and then purchasing a QLAC. If the defined benefit plan sponsor is willing to provide the QLAC through the defined benefit plan, the advantages noted above could be obtained and we see no policy reason for prohibiting the provision of such an annuity from a defined benefit plan.

Death Benefits

Under the proposed regulations, the only benefit permitted after an employee's death is "a life annuity, payable to a spouse or designated beneficiary, that meets certain requirements."

The committee appreciates the rationale for these requirements and recognizes this maximizes the QLAC income for the employee. We understand that the remaining account balance can provide significant death benefits if an employee dies early, and acknowledge that significant death benefits are inconsistent with the purpose of a QLAC.

Despite this understanding, however, we have concerns regarding the level of death benefits permitted with QLACs. When we examine data on annuity sales, which are designed to provide lifetime income, we observe that the overwhelming majority of immediate annuity sales in the United States are not simple life annuities; almost all have death benefits of a number of years certain or a refund of premium.[3]. Applying behavioral economics to this information raises a concern that individuals may not opt for QLACs if the death benefit alternatives are not expanded.

Based on this experience, individuals likely will not invest in a long-deferred annuity with insufficient death benefits. Individuals typically analyze this investment as separate from the remaining account balance. Married couples could look at this and conclude their investment will be wasted if they both die early. Single retirees could see little value in the reduced lifetime income to a non-spouse beneficiary. While the annuity death benefits in the proposed regulations are understandable, these benefits should be supplemented with additional amounts.

[3] 2000-04 Individual Payout Annuity Experience Report, Society of Actuaries, April 2009.

We urge the Treasury Department and IRS to allow, at a minimum, the addition of a refund-of-premium death benefit. Without this change, we anticipate QLACs may not be widely used.

25 Percent Limitation

We applaud the Treasury Department and IRS for adopting a simple rule for the limitation on the amount of the QLAC purchase. The committee considered suggesting more complex ways to vary the percentage limit by age at purchase and age at commencement that might provide more actuarial consistency. But we concluded that simplicity was the better approach. We support the proposed limitation and our analysis of the level of the percentage limitation on the purchase leads us to believe that it will be adequate to provide reasonably level purchasing power over the lifetime of the individual.

$100,000 Limitation

The committee appreciates the need to have a dollar limit on the purchase of a QLAC, but we respectfully submit that this amount may be too low to help many retirees. Using the Treasury Department's calculation, this amount might provide $26,000 to $42,000 at age 85 if purchased at age 70. After 15 years of deferral at an inflation rate of 3 percent, this would provide the purchasing power of $16,700 to $27,000 in current dollars. Long-term care costs, an expense likely to be incurred during the payment period of a QLAC, would exceed this purchasing power significantly. These amounts will not support the longevity needs of many Americans. We suggest the dollar limitation be increased to $250,000.

Adjustment to Dollar Limitation

Rounding the adjustment of the dollar limit to multiples of $25,000 seems too restrictive with an initial limit of $100,000. The committee suggests that the limit should be rounded to multiples of $10,000, which is 10 percent of the initial limit. Should the dollar limit be increased to $250,000 as suggested above, multiples of $25,000 would be 10 percent of the initial limit and we would not suggest a change.

Cost of Living Increases

The definition of a QLAC excludes "…a variable contract under section 817, equity-indexed contract, or similar contract." Some may read "or similar contract" to exclude a cost-of-living indexed annuity. We do not think this was the intent. We believe that cost-of-living indexed annuities are significant and we suggest this be clarified by specifically stating that a cost-of-living indexed annuity that complies with 1.401(a)(9)-6 is permitted. We also note that an individual could use 100 percent of an account to purchase an immediate cost-of-living indexed annuity, so it seems appropriate one should be able to self-manage investments for several years and purchase a cost-of-living indexed annuity as longevity protection.

Variable Annuity or Similar Contracts

The definition of a QLAC excludes "…a variable contract under section 817, equity-indexed contract, or similar contract." This exclusion is too restrictive and will result in retirees being unable to adequately protect their purchasing power from the two major risks of inflation and longevity.

The preamble to the proposed regulations states "…the purpose of a QLAC is to provide a participant with a predictable stream of lifetime income." We respectfully submit that QLAC fixed annuities will prove inadequate for this purpose for retirees. The proposed regulations do not address a significant risk faced by retirees in their later years—the risk of inflation. Even in the relatively benign inflation environment that exists today, a 2 percent inflation rate reduces purchasing power by one-third over 20 years—a likely deferral period for a QLAC. Should inflation increase to the levels seen in the 1970s or 1980s, fixed QLACs would not accomplish the intended purpose.

We appreciate that there is little difference between a typical IRC Section 817 variable annuity and retaining the funds in the account balance. A Section 817 variable annuity also typically would provide a death benefit no less than the account balance, which would not be allowed in a QLAC. Variable QLACs, however, could be designed that would be significantly different. A variable QLAC should require that there is no surrender value after the time of purchase (the same as a fixed QLAC). Only annuity distributions should be available and death benefits should be subject to the same restrictions as other QLACs.

Variable QLACs could be designed to provide a participant with a stream of lifetime income and the potential of sustaining purchasing power. This may be particularly helpful in a low interest rate environment because fixed annuities are quite expensive when rates are low. By purchasing a variable QLAC, retirees would have an opportunity for their income protection to grow, providing more income protection than what could be achieved under a fixed QLAC. The price of this "upside potential" is the assumption of the risk that investment losses provide a lower income than could have been purchased through a fixed or cost-of-living indexed QLAC. The predictability of the income from variable annuities can be improved by the addition of a guaranteed minimum income benefit. This QLAC design also would provide a greater incentive for individuals to purchase a QLAC at younger ages, when they might otherwise be concerned about the opportunity cost of not investing their savings in equity-linked investments. This greater utilization of QLACs would, we believe, be consistent with the Treasury Department's stated objective of enhancing the retirement security of American workers.

A fixed QLAC provides a longevity guarantee and a guarantee of nominal investment returns for a long deferral period plus the balance of the lifetime of the purchaser and beneficiary. A cost-of-living indexed QLAC provides this investment guarantee on the basis of real investment returns rather than nominal returns. This is a long-duration guarantee and insurance companies may have difficulty finding securities to match these obligations. As a result, they will need to build in adequate margins to provide this guarantee. Retirees are likely to view a cost-of-living indexed QLAC as very expensive. A QLAC with a fixed cost-of-living adjustment that increases the income benefit at a fixed, predetermined annual rate, also may be viewed as being too expensive by retirees.

A variable QLAC could by itself provide longevity protection. There is little or no guarantee of investment results and thus no need to include additional margins. The annuity can be provided more efficiently. An individual wanting a more predictable stream of income can choose to invest in more conservative funds, or add one of the many available riders that guarantee minimum benefit levels. An individual wanting to protect purchasing power can choose to invest in a Treasury Inflation Protected Securities (TIPS) fund. An individual willing to take some risk to maintain or increase purchasing power can choose to invest in equity funds. Regardless of which fund the individual selects, the provider guarantees only longevity protection (except for minimum-benefit guarantee riders) and investment results are passed on to the individual.

The proposed regulations could be improved significantly by allowing QLACs to include variable annuities under constraints similar to the current minimum distribution regulations. A participant currently may purchase an immediate variable annuity that is deemed to be non-increasing if the assumed interest rate used to determine the periodic adjustment in benefits is no less than 3 percent. Variable QLACs could be designed with the same limitations on distributions and death benefits as fixed QLACs.

The preceding comments concerning variable QLACs apply similarly to equity-indexed QLACs. The recognition of equity-index-based investment returns during both the deferral period and while income is being paid would provide the potential of higher income value than is available with a standard fixed return, while providing the same degree of longevity protection.

Roth IRA Offset

The proposed regulations contained specific requests for comments on whether the QLAC rules should apply to Roth IRAs or if Roth IRA assets should reduce the limits otherwise applicable to QLACs.

Applying the disclosure rules for the purchase of longevity annuities to a Roth IRA purchase would be helpful. The disclosure rules for QLACs will be beneficial and are not unduly burdensome. The committee would support this requirement for Roth IRA purchases of longevity annuities. This also might be beneficial for any longevity annuity purchase. We see no reason to apply other QLAC rules to Roth IRAs. Any reduction of the QLAC limits to reflect assets in a Roth IRA or purchase by a Roth IRA likely would be burdensome and unlikely to produce beneficial results. We do not recommend modifying the rules for this purpose.

Conclusion

The proposed regulations are a significant step forward in helping retirees attain financial security. We appreciate the Treasury Department and the IRS giving consideration to these comments. Please contact Jessica M. Thomas, the Academy's senior pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Respectfully submitted,

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