SOCIETY OF ACTUARIES

Managing the Impact of Long-Term Care Needs and
Expense on Retirement Security Monograph

# Financing Future LTSS and Long Life through More Flexible 401(k)s and IRAs

## Executive Summary and Appendices

By Karl Polzer

Copyright 2014 by the Society of Actuaries.
All rights reserved by the Society of Actuaries. Permission is granted to make brief excerpts for a published review. Permission is also granted to make limited numbers of copies of items in this monograph for personal, internal, classroom or other instructional use, on condition that the foregoing copyright notice is used so as to give reasonable notice of the Society's copyright. This consent for free limited copying without prior consent of the Society does not extend to making copies for general distribution, for advertising or promotional purposes, for inclusion in new collective works or for resale.

Actuaries
Risk is Opportunity.[sm]

Executive Summary & Appendices

***Key Pieces of the Retirement Security Puzzle:***

# Financing Future LTSS and Long Life through More Flexible 401(k)s and IRAs

Karl Polzer

## Executive Summary

This paper proposes and evaluates changing 401(k) and Individual Retirement Account (IRA) rules to help address two major risks facing participants in defined-contribution (DC) retirement accounts: 1) the risk of outliving one's savings; and 2) the risk of having to pay substantial amounts for long-term services and supports (LTSS). The proposal would allow retirees to invest a portion of their DC retirement savings in a special retirement account for longer without penalty than under current tax rules and could provide additional tax incentives for money drawn from the accounts used to pay for LTSS or long-term care insurance (LTCI).

The administration recently took a significant step that could help DC account holders manage the risk of outliving their savings. On July 2, 2014, the Treasury Department and Internal Revenue Service (IRS) published a final rule allowing conversion of part of DC account balances into longevity annuities with guaranteed lifetime payments. The new rules allow DC account holders to use up to 25 percent of their account balance or $125,000 (whichever is less) to buy a longevity annuity without tax penalties that otherwise might result from noncompliance with existing minimum distribution rules.[i]

The policy change explored in this paper addresses issues facing policymakers in both the retirement and long-term care (LTC) financing arenas. Key findings and observations of the analysis are:

- DC plans increasingly are the predominant way that Americans save for retirement. Many, if not most, Americans participating in DC plans are at risk both of outliving their savings and of not having enough to cover future LTSS costs.

- Lack of awareness of these major financial risks, along with tax rules that incentivize withdrawal from DC accounts beginning just after age 70, make it more difficult for people to save and invest in order to prepare to meet these risks.
- In planning for retirement, people could benefit from education on how to balance the need for streams of income to cover everyday retirement living expenses with the risk of living a long time and future LTSS costs. Preparing for retirement needs and risks poses significant trade-offs.
  - Allowing DC account owners to keep a portion of their total balance invested without tax penalty could help them to increase their earnings through a longer investment time horizon. However, saving and investing to cover future risks in this way would mean that they could use less for living expenses early in retirement.
- Americans may be surprised by the modest levels of income that can be yielded from what may seem to be large amounts of DC savings.
  - For example, for each $100,000 in total IRA/401(k) balances, account owners now have to withdraw about $4,000 annually beginning at age 71 to avoid a stiff tax penalty. If funds in the accounts are earning an average of 2 percent annually after inflation, annual "minimum distributions" remain somewhat level, staying between $3,500 and $4,500 a year until age 96, but then decline below $3,000 at age 100.

- Based on available estimates of DC account balances, about 20 percent of families with the largest DC asset levels would have the ability to pre-finance all or a substantial amount of the cost of LTSS by putting 25 percent of their total DC retirement assets in a "LTSS/longevity" account. Money in the accounts could be used to pay LTCI premiums or to pay directly for LTSS. If families started early enough, it is possible that such accounts could help more people cover a substantial portion or all such costs. Even those with very low DC retirement asset levels might benefit from being able to set aside some funds for longer to better sustain quality of life if they happen to live a long time.
- Currently only about 10 percent of seniors have LTCI. Though still an important financing option, the LTCI market has experienced major problems over the past several years. Most policies do not cover catastrophic costs over a specified upper limit, and a large percentage of older people do not qualify to buy LTCI because they have pre-existing medical conditions.
- Creating LTSS/longevity accounts could play an important role as policymakers explore packages of reforms that attempt to help people who are financially able to take personal responsibility for financing LTSS while expanding social insurance to help those lacking the financial means to do so.
- Establishing federal catastrophic LTSS coverage, which is one option under discussion, could dovetail well with LTSS/longevity accounts by limiting individuals' financial risk.

If people knew they only had to cover three years of major LTSS costs, for example, it would be easier for those with moderate incomes to finance all or a major portion of these risks, especially if they started saving and investing early.

- Encouraging private savings for LTSS through tax incentives would increase federal costs but could also reduce Medicaid costs. Federal government costs could be mitigated by tilting tax advantages toward middle- and lower-income people and away from those with higher incomes.
- While using money in the DC retirement system to finance LTSS would be most advantageous to people with higher incomes and retirement savings levels, such a policy change could be part of a reform package improving retirement security and reducing risk for people across the economic spectrum.
    - For example, such a package also could include: providing federal catastrophic coverage for LTSS costs; having the federal government guarantee interest rates for retirement annuities for people of modest means; and raising Supplemental Security Income (SSI) levels. SSI provides funds for room, board and living expenses for the lowest-income aged, blind and disabled people receiving LTSS under Medicaid. SSI levels are currently far below the federal poverty level.

---

## Appendix A

As noted above, starting LTSS/longevity accounts earlier would give the funds more time to grow, and possibly make it easier to afford LTCI and meet underwriting requirements, allow people to take more investment risk with a higher yield, and allow people with lower accumulations to cover more LTSS costs. As shown below, a 50-year-old who invested $50,000 in a special account could draw $1,500 yearly to pay LTCI premiums with between $14,054 and $154,137 remaining in the account at age 95 if annual rates of return were between 2 and 4.5 percent. Paying a $2,000 premium would result in an account balance of $0 after age 85 if the account earned 2 percent annually; however, if earning 4.5 percent annually, this account would have $84,712 remaining at 95 while continuing to pay $2,000 premiums. If the person chose not to buy LTCI, by age 80 the $50,000 would grow to somewhere between $90,568 and $187,266 at annual rates of return of between 2 and 4.5 percent. By age 85, the amount would grow to somewhere between $99,994 and $233,367 assuming the same range of rates of return.

### Table 14

**Special LTSS/Longevity Account or IRA Balances, $50K Initial Investment (2014 Dollars) Starting at Age 50**

| | ***Self-Insured with No Withdrawals*** | | ***$1.5K LTCI Premium*** | | ***$2K LTCI Premium*** | |
|---|---|---|---|---|---|---|
| | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI |
| | | | | | | |
| **Age 50** | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 |
| **Age 65** | $67,293 | $96,764 | $41,353 | $65,588 | $32,707 | $55,196 |
| **Age 70** | $74,297 | $120,586 | $37,851 | $73,529 | $25,703 | $57,843 |
| **Age 75** | $82,030 | $150,272 | $33,985 | $83,424 | $17,970 | $61,141 |
| **Age 80** | $90,568 | $187,266 | $29,716 | $95,755 | $9,432 | $65,252 |
| **Age 85** | $99,994 | $233,367 | $25,003 | $111,122 | $6 | $70,347 |
| **Age 90** | $110,402 | $290,818 | $19,799 | $130,273 | $0 | $76,758 |

| **Age 95** | $121,893 | $362,412 | $14,054 | $154,137 | $0 | $84,712 |
|---|---|---|---|---|---|---|

Table 15 below provides an example of a 40-year-old starting a special account with $50,000. This person could draw $1,500 yearly to pay LTCI premiums with between $707 and $220,938 remaining in the account at age 95 if annual rates of return were between 2 and 4.5 percent. Paying a lower annual premium of $1,000 premium would result in an account balance of between $50,000 and $334,897 at age 95, if assuming the same range of rates of return.

If this person chose not to buy LTCI, by age 80 the $50,000 would grow to somewhere between $110,402 and $290,818 at annual rates of return of between 2 and 4.5 percent. By age 85, the amount would grow to somewhere between $121,893 and $362,412 assuming the same range of rates of return.

## Table 15

### Special LTSS/Longevity Account or IRA Balances, $50K Initial Investment (2014 Dollars) Starting at Age 40

| | ***Self-Insured with No Withdrawals*** | | ***$1K LTCI Premium*** | | ***$1.5K LTCI Premium*** | |
|---|---|---|---|---|---|---|
| | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI |
| | | | | | | |
| **Age 40** | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 | $50,000 |
| **Age 65** | $82,030 | $150,272 | $50,000 | $105,707 | $33,985 | $83,424 |
| **Age 70** | $90,568 | $187,266 | $50,000 | $126,259 | $29,716 | $95,755 |
| **Age 75** | $99,994 | $233,367 | $50,000 | $151,871 | $25,003 | $111,122 |
| **Age 80** | $110,402 | $290,818 | $50,000 | $183,788 | $19,799 | $130,273 |
| **Age 85** | $121,893 | $362,412 | $50,000 | $223,562 | $14,054 | $154,137 |
| **Age 90** | $134,579 | $451,632 | $50,000 | $273,129 | $7,710 | $183,877 |
| **Age 95** | $148,587 | $562,815 | $50,000 | $334,897 | $707 | $220,938 |

By investing earlier, a person could begin with a lower account balance. Table 16 below depicts a scenario in which $35,000 is put in a special account at age 40. This person could make $1,000 yearly LTCI payments with between $5,424 and $166,053 remaining in the account at age 95 if annual rates of return were between 2 and 4.5 percent. If paying a $1,500 annual premium, the success of the viability of the strategy would probably depend on the rate of return on investment. If this person paid a $1,500 premium and the account earned 4.5 percent annually, then he or she could continue paying premiums until age 95 and still have $52,094 left in the

account. However, if the account earned 2 percent annually, the person paying a $1,500 premium would exhaust funds in the account at about age 72.

If this person chose not to buy LTCI, by age 80 the $35,000 would grow to somewhere between $77,281 and $203,573 at annual rates of return of between 2 and 4.5 percent. By age 85, the amount would grow to somewhere between $85,325 and $253,689 assuming the same range of rates of return.

## Table 16

### Special LTSS/Longevity Account or IRA Balances, $35K Initial Investment (2014 Dollars) Starting at Age 40

| | ***Self-Insured with No Withdrawals*** | | ***$1K LTCI Premium*** | | ***$1.5K LTCI Premium*** | |
|---|---|---|---|---|---|---|
| | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI | 2% RoI | 4.5% RoI |
| | | | | | | |
| **Age 40** | $35,000 | $35,000 | $35,000 | $35,000 | $35,000 | $35,000 |
| **Age 65** | $57,471 | $105,190 | $25,391 | $60,625 | $9,376 | $38,342 |
| **Age 70** | $63,398 | $131,086 | $22,830 | $70,079 | $2,546 | $39,576 |
| **Age 75** | $69,996 | $163,357 | $20,002 | $81,861 | $0 | $41,112 |
| **Age 80** | $77,281 | $203,573 | $16,879 | $96,542 | $0 | $43,027 |
| **Age 85** | $85,325 | $253,689 | $13,432 | $114,839 | $0 | $45,414 |
| **Age 90** | $94,206 | $316,142 | $9,626 | $137,639 | $0 | $48,388 |
| **Age 95** | $104,011 | $393,971 | $5,424 | $166,053 | $0 | $52,094 |

## Appendix B

**Figure 5**

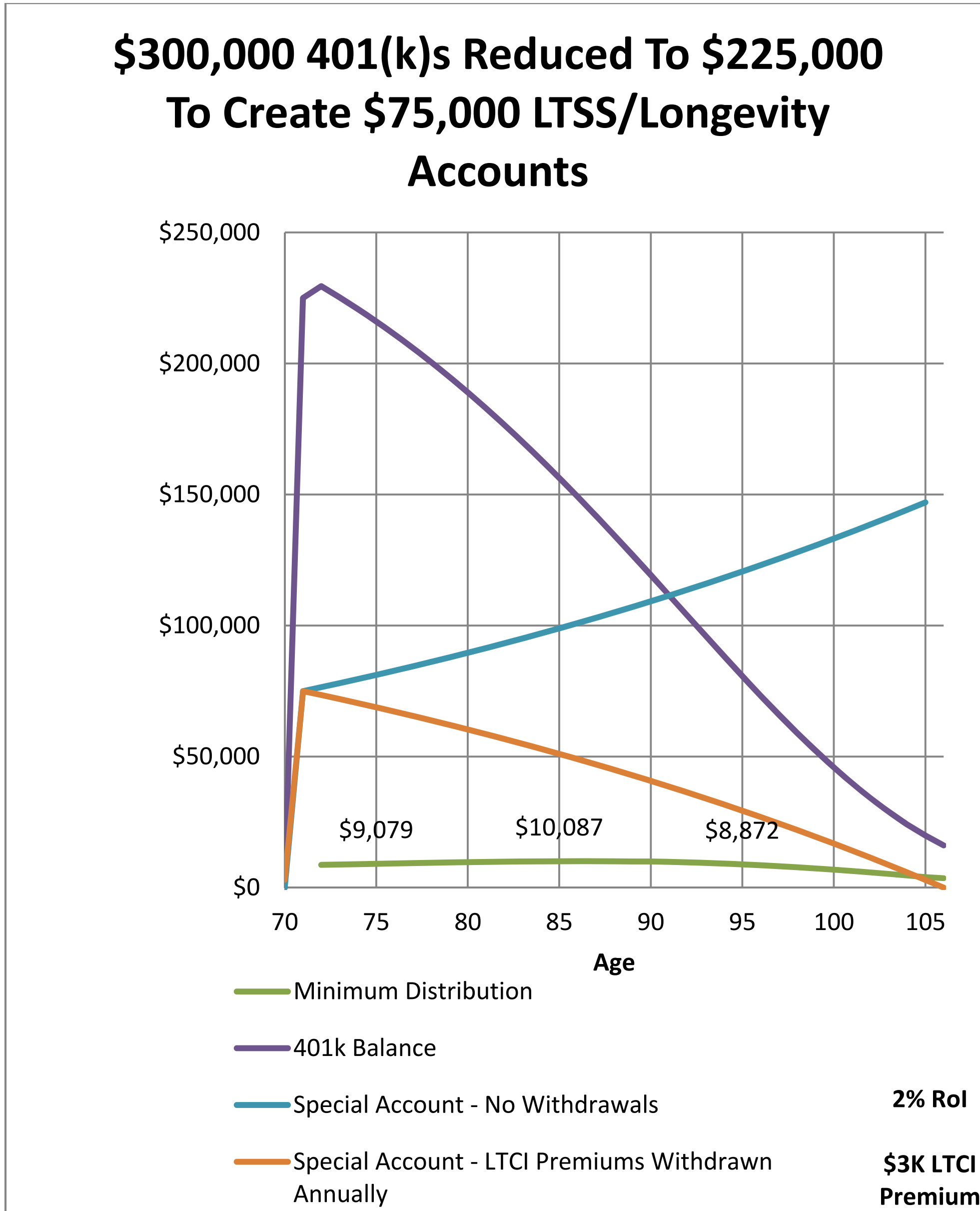


**Figure 6**

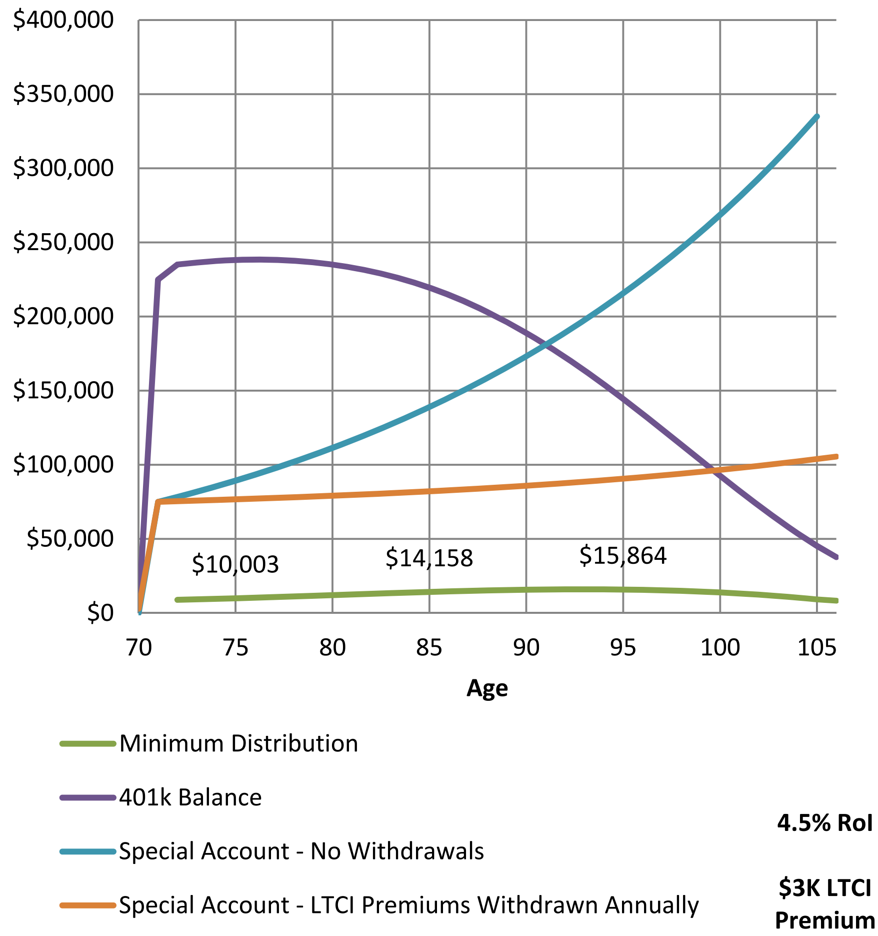


**Figure 7**

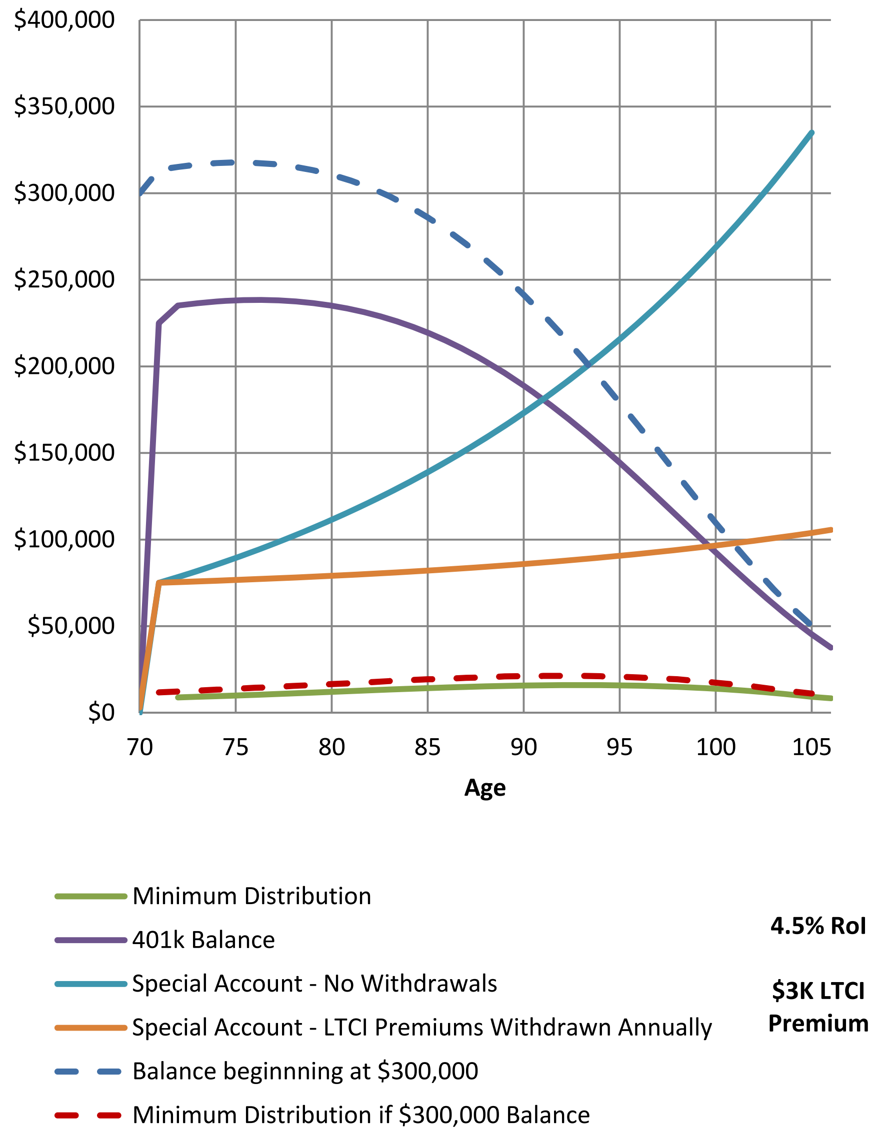


**Figure 8**

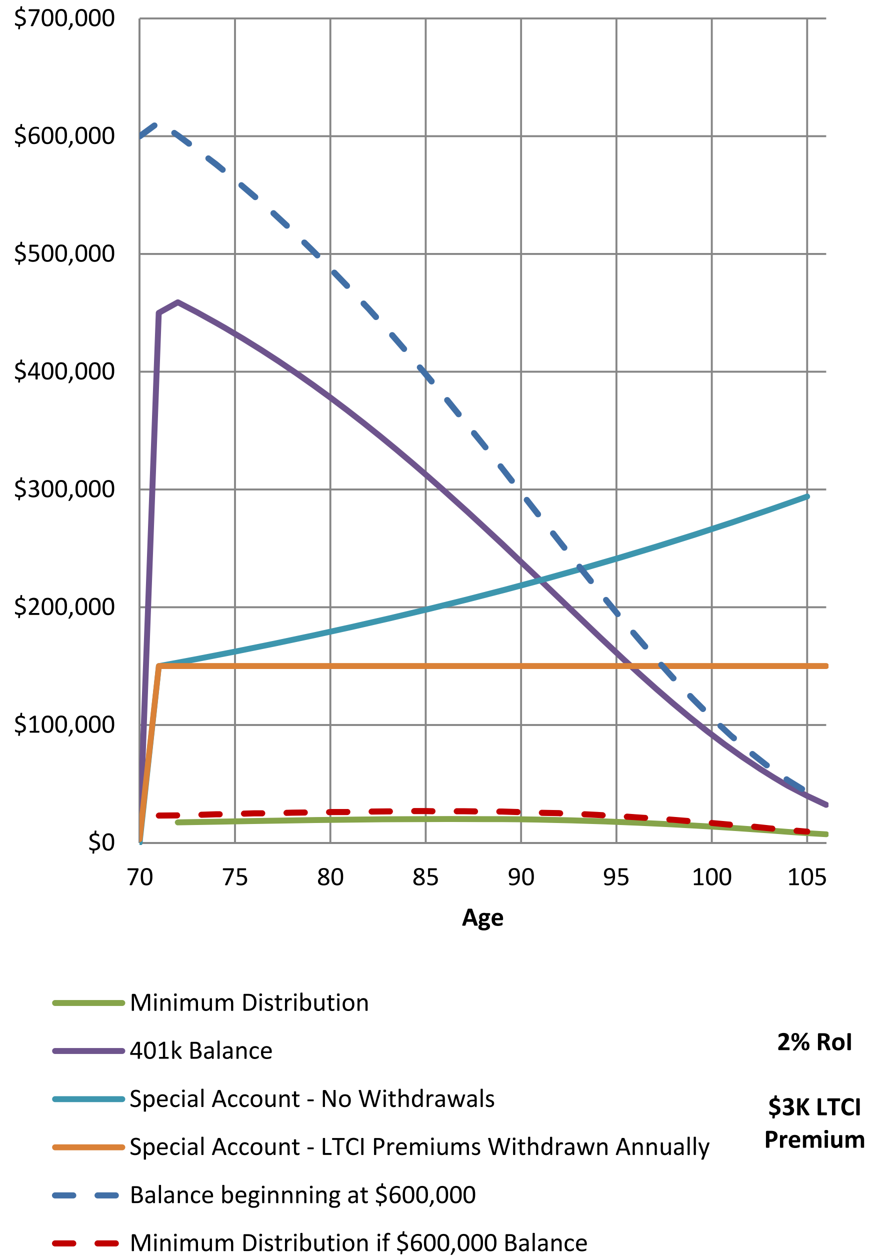
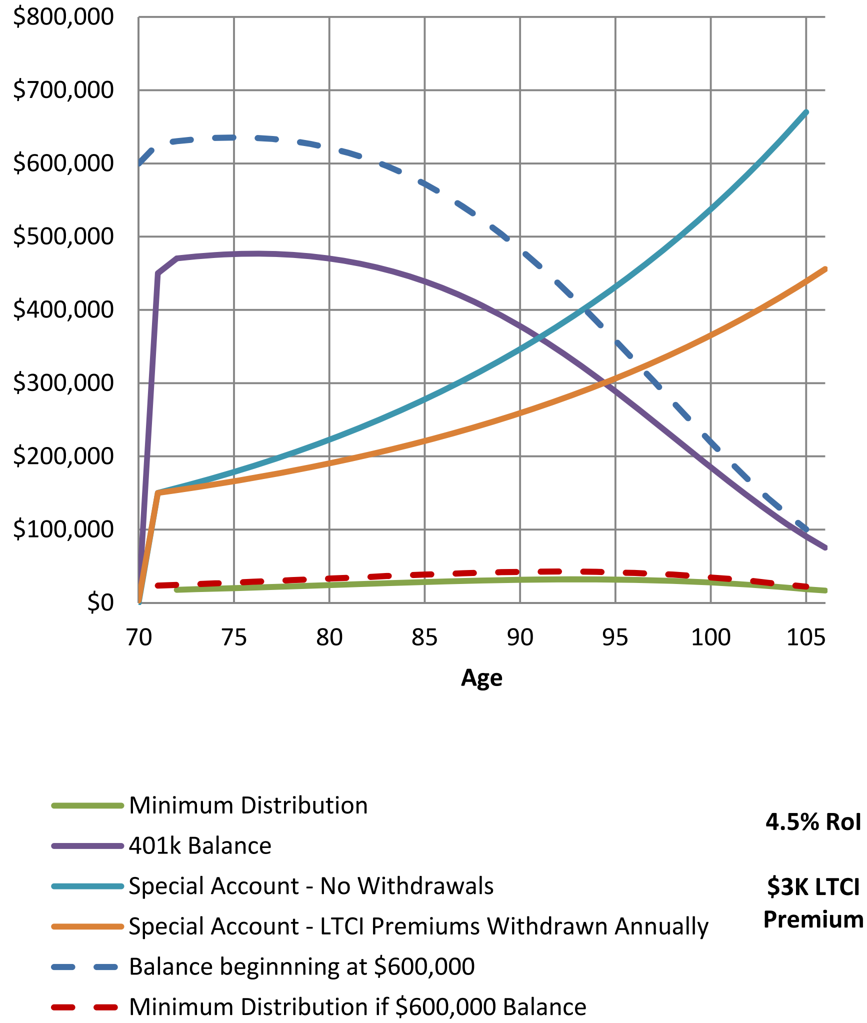


**Figure 9**



## Appendix C

**Table 17**

| **U.S. 2014 Poverty Guidelines for the 48 Contiguous States and D.C.** | |
|---|---|
| **Persons in family/household** | **Poverty guideline** |
| **1** | **$11,670** |
| **2** | **$15,730** |
| **3** | **$19,790** |
| **4** | **$23,850** |
| **5** | **$27,910** |
| **6** | **$31,970** |
| **7** | **$36,030** |
| **8** | **$40,090** |
| For families/households with more than eight persons, add $4,060 for each additional person. | |

Source: U.S. Department of Health and Human Services website: http://aspe.hhs.gov/poverty/14poverty.cfm, April 18, 2014.

---

[i] Federal Register, Vol. 79, No. 127, July 2, 2014, p. 37633. Also, see: "Treasury Green Lights Longevity Annuities in 401(k)s and IRAs," *Forbes*, July 1, 2014, downloaded from Web July 25, 2014 at: http://www.forbes.com/sites/ashleaebeling/2014/07/01/treasury-green-lights-longevity-annuities-in-401ks-and-iras/.