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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

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Key Pieces of the Retirement Security Puzzle:

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

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Abstract

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 income.

- 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.

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/>.