Insured Retirement Institute

Tax Policy and Middle-Income Boomers

The Importance of Tax Deferral in Attaining Retirement Security

March 2012

About the Insured Retirement Institute: The Insured Retirement Institute (IRI) is a not-for-profit organization that for twenty years has been a mainstay of service, commitment and collaboration within the insured retirement industry. Today, IRI is considered to be the authoritative source of all things pertaining to annuities, insured retirement strategies and retirement planning. IRI proudly leads a national consumer education coalition of nearly twenty organizations and is the only association that represents the entire supply chain of insured retirement strategies: our members are the major insurers, asset managers, broker dealers and more than 150,000 financial professionals. IRI exists to vigorously promote consumer confidence in the value and viability of insured retirement strategies, bringing together the interests of the industry, financial advisors and consumers under one umbrella. IRI's mission is to: encourage industry adherence to highest ethical principles; promote better understanding of the insured retirement value proposition; develop and promote best practice standards to improve value delivery; and to advocate before public policymakers on critical issues affecting insured retirement strategies and the consumers that rely on their guarantees. Visit www.IRIonline.org today to experience the vast resources of the Insured Retirement Institute for yourself.

Overview

Today's investors face unprecedented retirement income challenges—challenges that simply did not exist in earlier generations. The shift from defined benefit to defined contribution plans, longer life spans and the rising costs of healthcare are among the key elements that will put more of the burdens of saving for retirement on the shoulders of individual investors. Tax deferral of annuity earnings can, over the long-term, be instrumental in increasing the amount of savings that investors may accumulate for their retirement years.

This report is a follow-up to *The Tax Advantages of Annuities: How Tax Deferral and Guaranteed Lifetime Income Strategies Can Benefit All Consumers*, published by IRI in February 2011. Among the key findings of the earlier report was that the deferral of taxes on the inside buildup of annuity contracts is a key selling point for advisors and investors. Also, the present tax status of annuities encourages long-term savings in the products due to a longer horizon needed to counteract the ordinary income tax due on earnings when funds are withdrawn. Additionally, the tax deferred treatment of annuities is extremely important to the utilization of the products for middle class Americans, who comprise two-thirds of annuity owners.

In this report, we present new IRI research on the importance that Boomers place on tax deferral and taxation, in general, and the consequences of potential changes in taxation on middle income Boomers' likelihood to save for retirement.

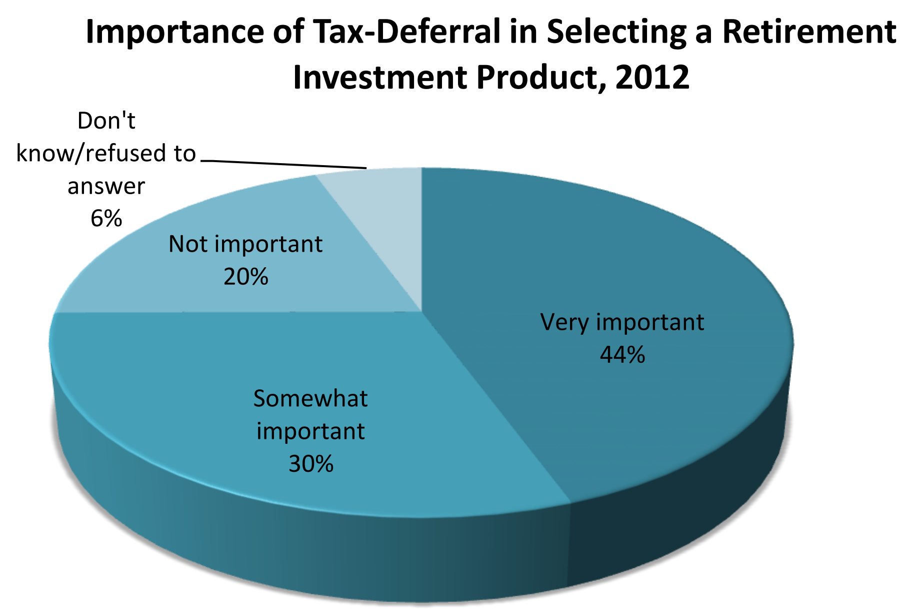
Key Findings and Analysis

- Tax deferral remains an important consideration for investors.
  - 74% of Boomers place some level of importance on tax deferral in selecting a retirement investment; 44% consider tax deferral a very important criterion.
  - Nearly half (48%) of Boomers between ages 50-54 consider tax deferral a very important feature of a retirement investment product, and another 29% rate tax deferral as somewhat important.
  - Nearly one-quarter of investors (23%) cited tax-deferred growth as the primary reason for purchasing annuities.
- Annuity owners are overwhelmingly middle-income. Eight in 10 buyers of non-qualified annuity contracts had annual household incomes of less than $100,000, including 64% who earned less than $75,000.
- Changes in tax laws would have the greatest impact on the ability of middle-income Boomers to save for retirement.
  - 76% of middle-income Boomers consider tax deferral an important criterion when selecting a retirement income product.
  - 59% of middle-income Boomers would curtail their level of retirement savings should income taxes increase, and 37% would be less likely to save should Social Security payroll taxes increase.
  - 24% of middle-income Boomers would be less likely to save for retirement if tax deferral is reduced or eliminated.

- Approximately half (55%) of advisors consider tax-deferred growth an important factor when evaluating and selecting annuities, and 20 expect tax deferral to take on greater importance in the next five years.
- Higher income tax rates would greatly impede retirement savings. More than half (54%) of Boomers related that they would be less likely to save for retirement should their income taxes rise.
- Taxes on retirement savings and annuities are deferred, not excluded.
    - As individuals begin to retire, distributions from annuities are taxed and revenue will flow to the U.S. Treasury.
    - Annuity distributions are treated as income rather than capital gains.

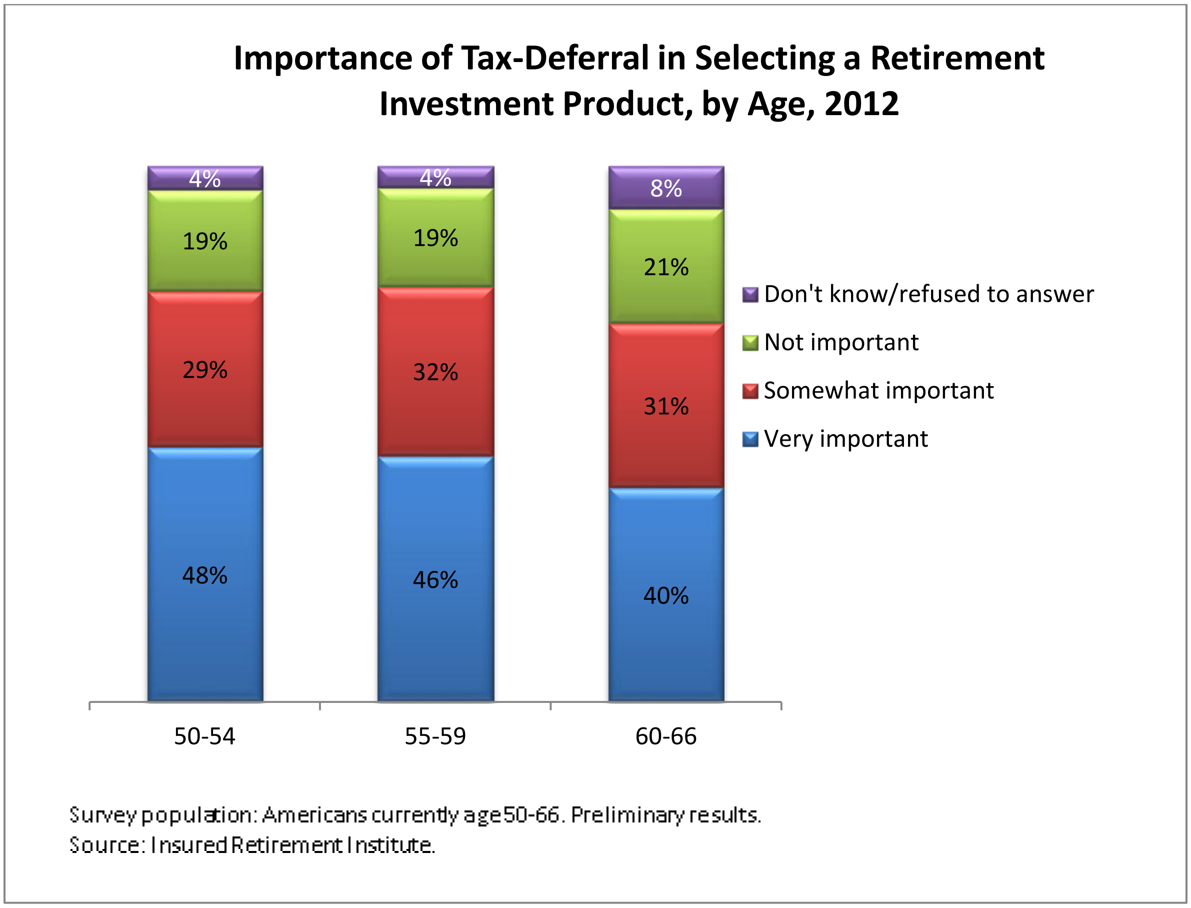
The Value of Tax Deferral

Although the emphasis on annuity benefits is on guaranteed retirement income, tax deferral remains an important consideration for investors. According to IRI research, three quarters of Boomers place some level of importance on tax deferral in selecting a retirement investment; 44% consider tax-deferral a very important criterion.



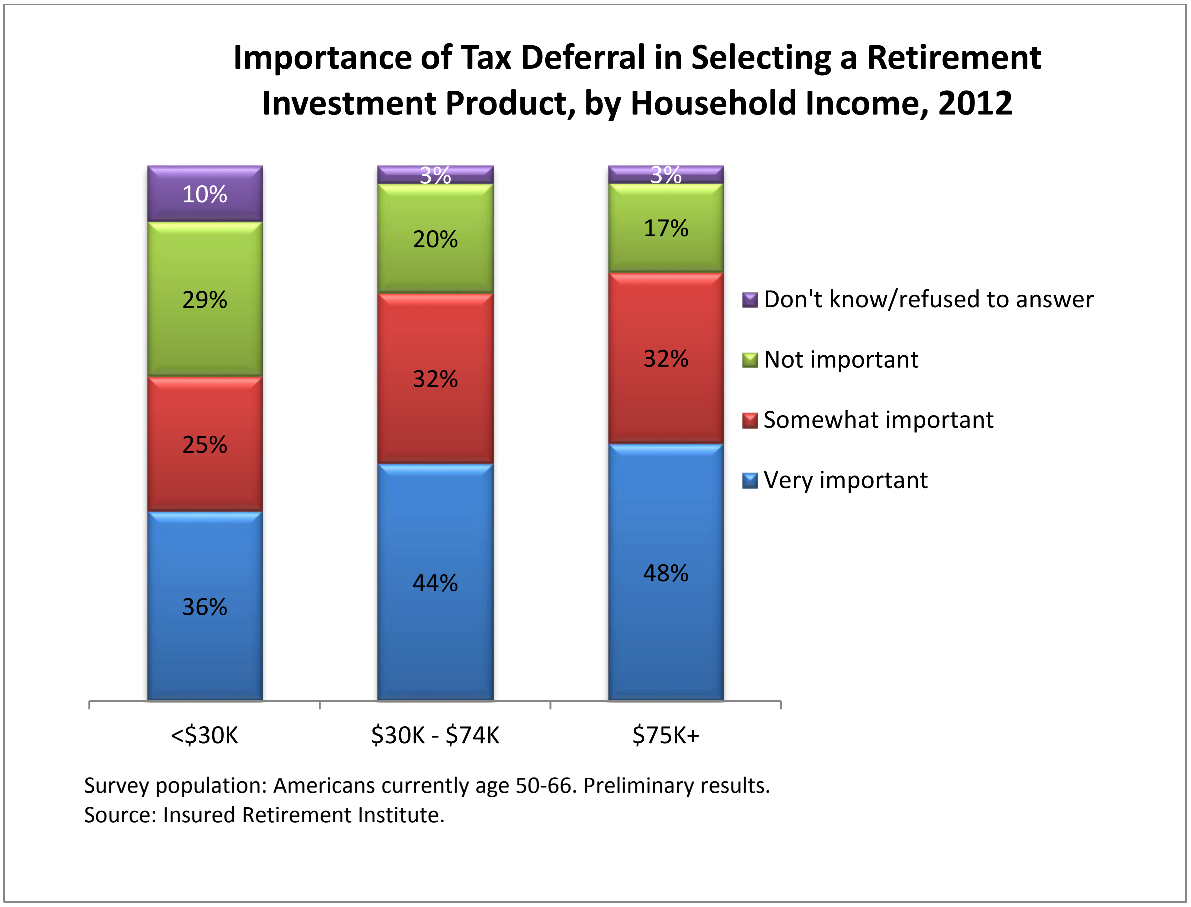
Survey population: Americans currently age 50-66. Preliminary results.
Source: Insured Retirement Institute.

A closer look at the data reveals that tax-deferral is of greatest importance for younger Boomers and those with household income of at least $30,000. Nearly half (48%) of Boomers between ages 50-54 consider tax deferral a very important feature of a retirement income product, and another 29% rate tax deferral as somewhat important. These figures decrease slightly as Boomers age, likely due to the short time horizons they perceive, yet the results are still telling. Among the older Boomers—those in their 60s—four in ten cite tax deferral as very important and three in ten assign a level of somewhat important.



Similar trends are seen by level of household income. Not surprisingly, Boomers in higher tax brackets are more likely to consider tax deferral as a criterion for retirement savings—yet middle-income Boomers are just as concerned. Three-quarters of middle-income Boomers consider tax deferral to be an important criterion for retirement savings. And, as we will see later in this report, 24% of middle-income Boomers would be less likely to save for retirement if tax deferral is reduced or eliminated.

The distinction of middle income investors is an important one. Research conducted by Mathew Greenwald and the Gallup Organization indicates that 80% of buyers of non-qualified annuity contracts in 2009 (the most recent biennial survey available) had annual household incomes of less than $100,000 and 64% earned less than $75,000.



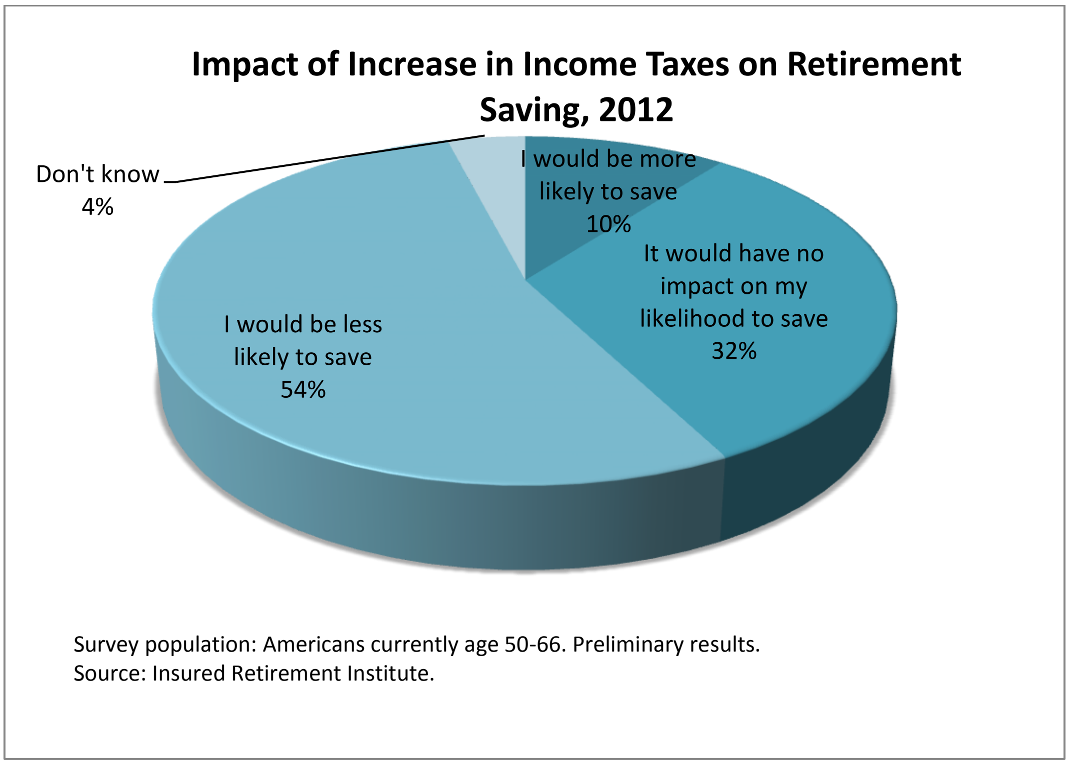
Separate research from IRI and Cogent Research also illustrates the importance that investors place on tax deferral. In the report, *The Evolution of the Annuity Industry: Analyzing Growth, Trends and Opportunity in the Annuity Industry*, published by IRI and Cogent Research in November 2011, nearly one-quarter of investors (23%) cited tax-deferred growth as the primary reason for purchasing annuities, ranking behind guaranteed income in retirement (34%) and advisor recommendation (27%) yet significantly ahead of principal protection (9%) and death benefits (3%).

The same report also sheds some light on the opinions of financial advisors. Approximately half (55%) of advisors consider tax deferred growth an important factor when evaluating and selecting annuities. Additionally, 20% of advisors expect tax deferral to take on greater importance in the next five years (78% expect no change). Although this level of importance is considerably less than that assigned to carrier financial stability (93%), guaranteed income options (89%), and investment options (73%), it illustrates that tax deferral still carries some weight when evaluating retirement income products.

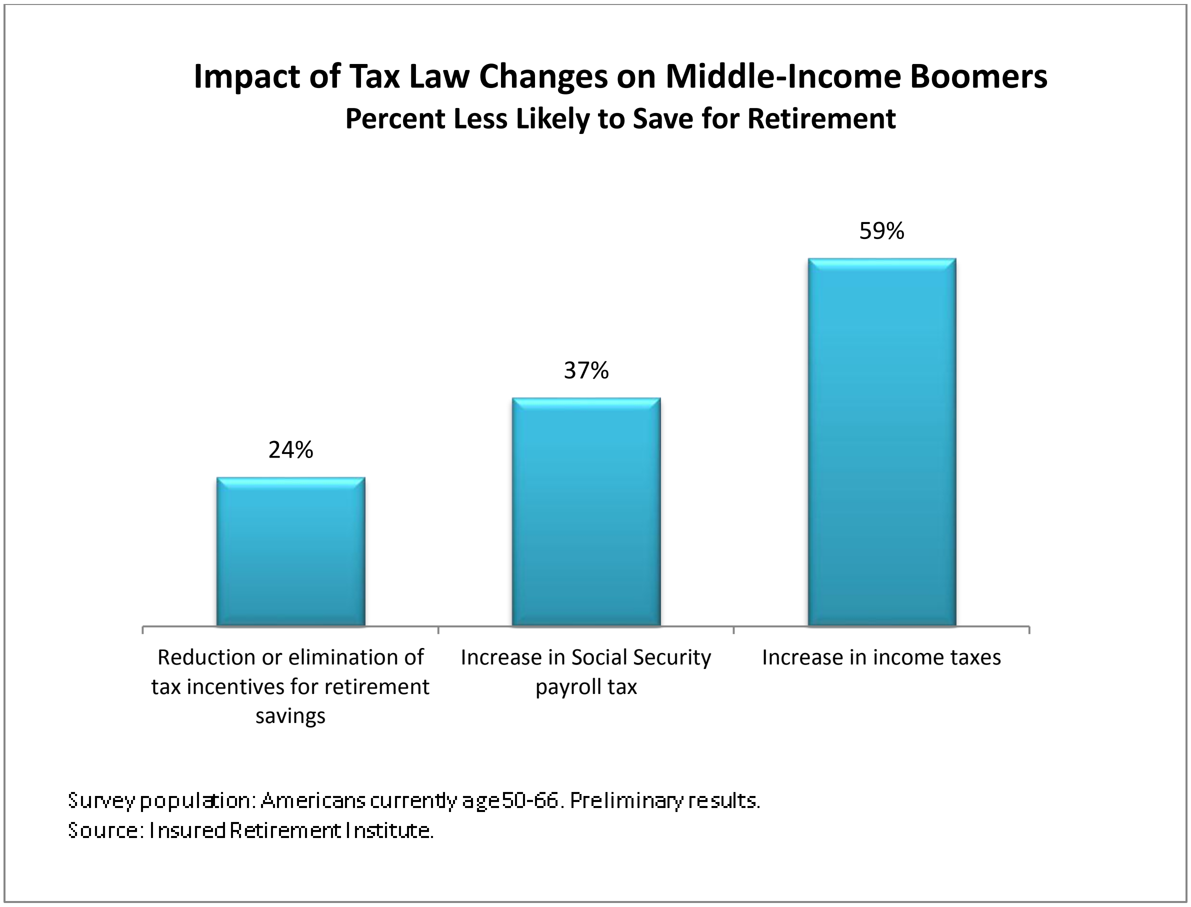
It must be reiterated that taxes on retirement savings and annuities are deferred, not excluded. Deferral treatment is not equivalent to the exclusion associated with other tax expenditures. As individuals begin to retire, distributions from annuities are taxed and revenue will flow to the U.S. Treasury. Therefore, the removal of the tax-deferred status of annuities would not necessarily increase the tax revenue generated by the products. Yet, it would result in the reduced use of annuities among the populations that have come to rely on them most—middle-income investors.

Income Taxation and Middle-Income Boomers

Given the ongoing discussions in Congress about income taxation, IRI set out to quantify the impact of tax increases on Americans' likelihood to save for retirement. Not surprisingly, higher tax rates would impede retirement savings—yet the magnitude of this impact is quite high. More than half (54%) of Boomers related that they would be less likely to save for retirement should their income taxes rise. As annuity withdrawals are taxed at ordinary rates, this would also have a great impact on annuity owners, most of whom are middle-income investors. If combined with a reduction or elimination of tax-deferral benefits on annuities, a rise in income taxes would be a great burden to middle- income annuity holders during the many years in which they are saving for retirement.



Nearly 60% of Boomers in their 50s expressed that their ability to add to their retirement savings would be negatively impacted by higher income taxes. This is of concern for several reasons. First, younger Boomers will require a greater reliance on personal savings for retirement than older Boomers due to the migration from defined benefit to defined contribution plans. Second, with less money, if any, to put aside, the benefits of tax-deferred compounding are also reduced, leaving them with a smaller nest egg at the time of retirement.



The reduced likelihood to save should their income taxes increase is most pronounced among middle-income Boomers. Additionally, an increase in Social Security payroll taxes would likely result in reduced retirement savings among nearly 40% of Boomers. This can be detrimental to the long-term retirement security for the same reasons as mentioned above—plus, this segment of Boomers will need to rely on more than Social Security to ensure a comfortable retirement. According to the IRI report, *Middle-Income Boomers and Retirement: Tapping the Significant and Underserved Middle-Income Market*, only 48% of middle-income Boomers expect Social Security to comprise a major portion of their income during retirement, and only 38% expect to rely heavily on traditional pension plans.

Additionally, 21% of middle-income Boomers expect personal investments to play a significant role in providing income during retirement, compared to 36% of Boomers in higher-income brackets. It is essential, therefore, that middle-income Boomers be encouraged to save on their own for their future retirement expenses. Increased taxation, whether in the form of higher income taxes or the loss of the tax-deferral of earnings, will have the opposite effect for close to two-thirds of this population.

Conclusion

IRI research shows that Boomer expectations for retirement are clouded by concerns about savings and income. For example, three out of ten Boomers cite concern about having sufficient assets as a top issue as they plan for their retirement years. Annuities are designed to help provide guaranteed income for all Americans who seek to ensure a stable and secure financial future, regardless of access to an employer-sponsored retirement plan. Annuities, therefore, can play an important role in helping to address the potential challenges that retirees face, such as: longevity risk, entitlement risk, inflation risk and medical expense risk that all Americans must consider as they plan for retirement.

Millions of Americans have come to rely on annuities for a secure retirement, and eliminating or diminishing the current tax treatment of these products will jeopardize their retirement savings at a time they can least afford it. Nearly three-quarters of Boomers consider tax deferral an important factor in selecting a retirement-investment product, as do more than half of financial advisors. Additionally, more than half of Boomers anticipate having to curtail their retirement savings should their income taxes rise. Younger Boomers and middle-income Boomers are the most likely to experience these negative consequences.

While IRI applauds the efforts of the United States Congress to address the deficit, it is imperative that we protect the tax deferral of annuity earnings so that all Americans will have access to these important savings vehicles.

Methodology

The Insured Retirement Institute (IRI) commissioned Woelfel Research, Inc. to conduct a survey of Boomers approaching retirement or who have recently retired. The research was conducted by means of telephone interviews with adult Americans aged 50-66. Preliminary results based on a sample of 503 individuals are presented. The sample was selected from a list of households in this age group, developed by Accudata, Inc. by compiling data from available sources such as motor vehicle records. Results were weighted by age and gender to the 2010 United States Census. Data was collected during February and March 2012.