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## Retiree Annuity Purchase

### INITIAL CONSIDERATION

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### ISSUE STATEMENT

The Legislature enacted the Board's 2013 proposal allowing retiring LEOFF Plan 2 members to roll over tax deferred savings into LEOFF Plan 2 to purchase an annuity, RCW 41.26.463. Current state law limits roll overs to the time of retirement.

### OVERVIEW

Following passage of the law, retirees inquired whether they could roll over and purchase an annuity after retirement. Staff has determined retiree annuity purchase is permissible under the internal revenue code if the LEOFF Plan 2 act were amended to allow it.

At the time of retirement, members can roll their retirement savings from a tax qualified plan into LEOFF Plan 2. The Department of Retirement Systems (DRS) will convert this rollover into a monthly life annuity. Because members are rolling over from a tax qualified savings plan, they do not have to pay taxes at the time the annuity is purchased. Instead, the money will be included in their taxable income as they receive it.

Members receive their pension dollars as well as this annuity in one monthly check from DRS. If they were to pass away before receiving the initial cost to purchase the annuity, the designated beneficiary receives the balance.

### BACKGROUND & POLICY ISSUES

#### Other annuities

Many private annuity companies offer their own versions of this benefit. However, LEOFF's higher interest rate assumption (7.5% - compared to around 4% for a private annuity company) translates into a larger annuity from the same lump sum. Additionally, administrative cost to the member are much lower.

Analysis supporting the Board's 2013 annuity purchase proposal is included in the December 18, 2013 final proposal to the Board attached as exhibit A.

### **Retirees may purchase an annuity**

A 2012 IRS revenue ruling<sup>1</sup> allowed pension plan member to roll money from a deferred compensation account into the member's defined benefit plan to purchase an annuity if authorized by the plan document (i.e. the LEOFF Plan 2 statutes). The original revenue ruling did not discuss whether retirees could also be given that opportunity.

The bill proposed by the Board and passed by the Legislature limits roll over and annuity purchases to the time of retirement. Following questions raised by retirees, staff has determined that federal tax law allows retirees to take that same action if authorized in statute.

## **SUPPORTING INFORMATION**

Appendix A: Promoting Individual Savings for Retirement – Final Proposal, December 18, 2013

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<sup>1</sup> Internal Revenue Bulletin 2012-8; issued February 21, 2012.



DECEMBER 18, 2013

## PROMOTING INDIVIDUAL SAVINGS FOR RETIREMENT

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### FINAL PROPOSAL

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### ISSUE

Members are not able to take advantage of a recent IRS ruling which provides new options for managing savings in retirement.

### PROPOSAL SUMMARY<sup>1</sup>

At the November 20<sup>th</sup> meeting the Board directed staff to prepare proposals on:

- Option 1: Authorize LEOFF Plan 2 to annuitize roll-overs of tax deferred savings;
- Option 3: Require LEOFF Employers to Offer DRS's Deferred Compensation Program to LEOFF Members; and
- Option 4: Encourage DRS to offer a Roth option as part of its 457 deferred compensation plan.

Those options are being presented for Board action at the December 18<sup>th</sup> meeting.

### MEMBERS IMPACTED

New options encouraging member's retirement savings as part of LEOFF Plan 2 would be available to all 16,720 active LEOFF Plan 2 members<sup>2</sup>.

### OVERVIEW

The LEOFF Plan 2 defined benefit Plan, the first leg of the three-legged retirement stool, provides a defined lifetime payout that does not vary with investment return. Retirees must devise their own distribution strategy for the second leg of the stool, individual retirement savings. Members can reduce the risk of outliving their assets if they convert at least some of those assets into a lifetime annuity.

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<sup>1</sup> The Board initially considered this issue at the August 28, 2013 Board meeting. At the September follow-up the Board looked at three options and requested additional information on: Annuitization of additional amounts rolled over into LEOFF Plan 2; and requiring LEOFF employers to participate in DRS's 457 plan. Staff also researched authorized "Roth" accumulations in governmental 457 plans.

<sup>2</sup> Membership number as of June 30, 2012; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.

LEOFF Plan 2 members may purchase an additional monthly benefit through the LEOFF Plan 2 trust fund by buying up to 5 years of additional service credit at the time retirement. Under current law, only Plan 3 members (TRS, PERS & SERS<sup>3</sup>) can convert contributions to an annuity from their retirement system.

Leveraging the existing LEOFF Plan 2 infrastructure to authorize accumulation of savings and/or converting that account to a monthly benefit through the LEOFF Plan 2 trust fund would provide a cost-effective mechanism to encourage retirement savings. This can be particularly important for LEOFF Plan 2 members since many do not participate in social security through their employer.

This report examines federal laws encouraging retirement savings, the costs of savings for retirement, different mechanisms for annuitizing retirement savings, a recent IRS ruling authorizing annuitizing retirement savings through LEOFF Plan 2, and provides options for further action.

## BACKGROUND INFORMATION & POLICY ISSUES

The LEOFF Plan 2 Retirement Board began studying ways to encourage increased retirement savings during the 2004 Interim. The Board recommended legislation allowing purchase of up to five years of service credit at retirement. The Legislature passed that recommendation in 2005 (HB 1269).

That same year the Department of Retirement Systems (DRS) began offering annuities through the Plan 3 programs. The Purchase of Annuity topic was studied by the Board during the 2006, 2007, 2008 and 2009 Interims reaching the Final Proposal stage in 2006, 2008 and 2009, but no legislation was recommended. The topic was deferred for joint consideration with the Select Committee on Pension Policy (SCPP) for the 2009 Interim. No further action was taken.

*The paradox is that investors recognize that their retirement savings will need to last longer than ever before but they aren't making plans to ensure they will actually have the money they need. There tends to be a false sense of security when it comes to Planning for retirement. We hope that the money will somehow be there when we need it but we're not taking the action required to ensure it is. This is a serious problem, and addressing it must become an urgent priority.*

Noel Archard, Head of BlackRock  
Canada. July 2013

## SAVING FOR RETIREMENT

### Federal Law Encouraging Retirement Savings

<sup>3</sup> Teachers' Retirement System (TRS); Public Employees' Retirement System (PERS); School Employees' Retirement System (SERS).

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The federal tax code encourages individuals to save for, and invest in, retirement:

- Qualified deferred compensation plans, such as the IRS §457 plan offered through the Department of Retirement Systems (DRS) deferred compensation program, permit an individual to authorize pre-tax salary deductions for deposit into a personal investment account. Many LEOFF Plan 2 employers offer these types of plans to employees. Upon separation from employment a member may leave the funds invested or select a distribution option.
- Members may transfer funds between government defined benefit pension Plans like LEOFF Plan 2 and deferred compensation accounts such as 457, 403(b), and 401(k) Plans. This helps members manage retirement savings as they change employers.
- Purchase of up to five years of service credit or “air-time” was authorized in the Federal Pension Protection Act.
- A recent IRS revenue ruling<sup>4</sup> allows members with funds in a deferred compensation account maintained by an employer to roll the funds over into their defined benefit plan and convert those funds to an annuity from the defined benefit Plan.
- The Small Business Jobs act of 2010 authorized governmental 457 plans to include a Roth option.

Using these federal provisions, some state and local government pension plans allow member fund transfers, including funds from tax-deferred accounts, into the primary defined benefit plans to purchase additional service credit or an annuity.

### **THE COST OF SAVING - DEFERRED COMPENSATION FEES**

DRS operates a deferred compensation program under 26 U.S.C. §457, commonly called a "457 Plan". Washington's political subdivisions may participate in DRS's 457 Plan, or use another administrator, such as ICMA-RC. Administrative fees vary significantly. Comparing private administrator fees to DRS's annual .13% fee can be challenging since private administrators tend to use variable fee schedules rather than the flat fee charged by DRS, as demonstrated by the fee comparison table included as Appendix A.

The average net annual fee of the private 457 plan administrators examined in Appendix A is 1.29%, nearly 10 times the .13% charged by DRS. DRS's lower fees facilitate a larger accumulation from the same member contributions<sup>5</sup>:

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<sup>4</sup> Internal Revenue Bulletin 2012-8; issued February 21, 2012.

<sup>5</sup> The comparison assumes \$3,602 per year contribution for 15 years, earning interest at LEOFF PLAN 2's assumed rate of 7.5%, less annual fees.

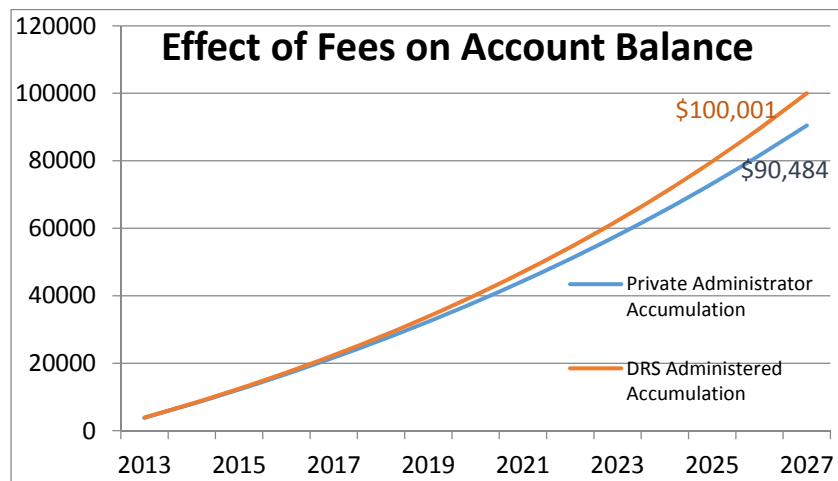


Figure 1

## ANNUITIZING ASSETS

Annuities can convert retirement savings into a guaranteed monthly income (this process is called annuitization) for a specified period of time. A life annuity provides that income for the member’s lifespan in exchange for a lump-sum dollar amount paid up front. Deferred compensation plans do not normally allow for the distribution of assets in the form of an annuity directly from the fund. LEOFF Plan 2 members wishing to annuitize their retirement savings must purchase the annuity through an insurance company.

The price/value of the annuity depends in part upon the features selected by the purchaser. The terms and conditions of an annuity contract specify features such as whether the annuity will be for a single life or a joint annuity (like a survivor benefit feature), the payment frequency, adjustments for cost of living, and death provisions. Different methods for annuitizing assets are listed below, though not all are currently available to LEOFF Plan 2 members.

### Trust Fund Annuity Purchase

TRS Plan 3, SERS Plan 3, and PERS Plan 3 members and survivors may convert some or all of the funds from their Plan 3 member account to a life annuity, RCW 41.50.088. The features and options of the Plan 3 annuities administered by DRS are detailed in Appendix B. This option is not available to LEOFF Plan 2 members.

DRS calculates the annuity that can be purchased for a given lump sum using an age based actuarial table to compute the monthly benefit per \$1.00 of accumulation for defined benefits. There is no limit on the amount of funds in the member account that can be converted to an annuity.

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RCW 41.32.067 also allows TRS Plan 1, 2 and 3 members to purchase additional benefits through a member reserve contribution which is actuarially converted to a monthly benefit at the time of retirement. The statute was passed to provide teachers with out-of-state service credit a mechanism for transferring contributions from a prior system into TRS<sup>6</sup>.

### **Service Credit Purchase**

LEOFF Plan 2 members can annuitize retirement savings by purchasing up to five years of additional service credit at the time of retirement. To purchase service credit under this option the member pays the actuarial present value of the resulting increase in the member's benefit. A member may pay all or part of the cost of the additional service credit with an eligible transfer from a qualified retirement plan. For more information on the history and methodology for calculating service credit purchases, see Appendix C.

The federal 5-year “air time” limit works out to a maximum of \$86,484 that could be converted to a monthly benefit by the average LEOFF Plan 2 member<sup>7</sup>, see Appendix C. This is a key difference between a Plan 3 annuity conversion and a service credit purchase: the Plan 3 conversion does not have a maximum amount limit.

### **Commercial Market Annuity**

Retirement savings can be annuitized by purchasing an annuity policy through insurance agents, financial planners, banks and life insurance carriers. However, only life insurance companies issue policies. Generally, commercial market annuities do not offer all the same features as the Plan 3 trust fund annuity and do not provide as favorable a payout. A primary reason for the payout difference is the different interest rate used to calculate the value of the annuity. Private insurers use a lower interest rate, due in part to the inclusion of a reasonable profit:

[A] private insurer will provide the annuity based on an interest rate of about 4 percent, whereas DRS will provide the annuity based on an interest rate of about 8%.<sup>8</sup>

The interest rate differential drives a significant difference in payout amounts between private annuity contracts and contributions annuitized through the trust fund. Five different insurance companies quoted the monthly annuity with a 3% annual COLA they would provide the average LEOFF Plan 2 retiree<sup>6</sup> for \$100,000:

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<sup>6</sup> See Laws of 1991 c 278 § 2.]

<sup>7</sup> Age 56 with 17 years of service credit and a final average salary of \$5000 per month.

<sup>8</sup> 2010 State Actuary 2010 fiscal note on the Board’s purchase of annuity proposal.

Insurance Company	Quote
American General	\$389
Aviva	\$402
Fidelity & Guaranty Life	\$421
Genworth Life Insurance	\$406
Integrity Life Insurance	\$400
<b>Average</b>	<b>\$404</b>

If that same average LEOFF Plan 2 member were able to leverage the institutional advantages of the retirement system by annuitizing \$100,000 within the LEOFF Plan 2 system, the payout would be \$578.14<sup>9</sup>. That’s a 43% increase over the average commercial quote, or \$174 more per month for life.

The chart below uses the 15 year accumulations calculated in figure 1 and estimates the annuity those accumulations would purchase from either an insurance company or the LEOFF Plan 2 trust fund.

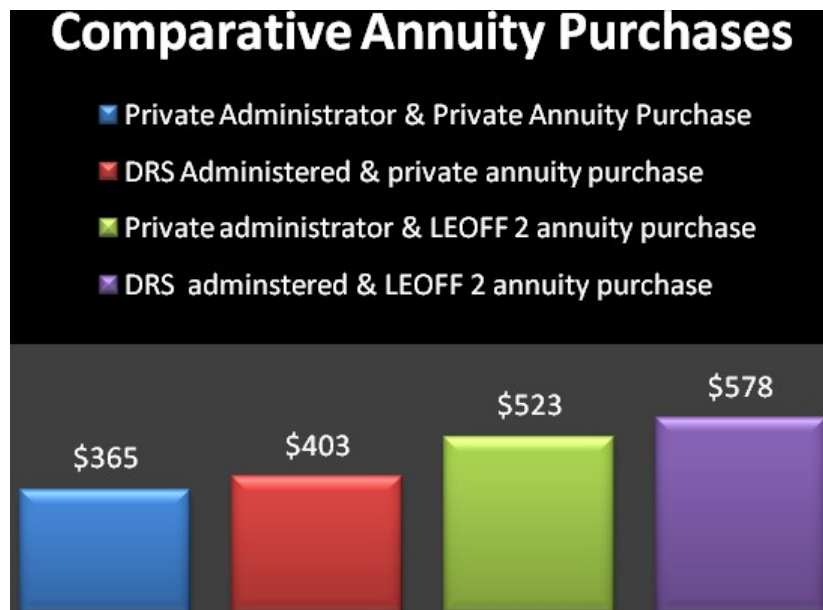


Figure 2

Current state law does not allow annuitization of retirement savings through the LEOFF Plan 2 trust fund. A recent IRS ruling gives the green light to such a program.

<sup>9</sup> \$100,000 x .0057814 (conversion factor from DRS table for 56 year-old LEOFF member) = \$578.14 monthly life annuity



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## **NEWLY AVAILABLE ALTERNATIVES:**

### **Annuitization through 401(a) plan**

Federal tax law allows public defined benefit plans to add a member savings account within the plan, sometimes referred to as a companion account or “sidecar”. Contributions to the employee savings account may be made by the employer or the employee and may be either pre-tax or after tax depending on plan design.

Under the recent IRS ruling cited above, a retirement savings account can be annuitized within the 401(a) defined benefit plan to obtain an additional monthly benefit paid through the trust fund. This can be done either through a employee savings account administered within the 401(a) plan or by rolling over retirement savings from another plan such as a 457 plan.

A “sidecar” plan administered through LEOFF Plan 2 could leverage the institutional advantages available to active members as participants in an existing state-administered Plan. Those advantages include the lower fees charged by DRS to administer the savings plan, and the more favorable annuity payout when purchased through the existing LEOFF Plan 2 trust fund.

### ***Potential Risks***

The purchase of an annuity through the LEOFF Plan 2 trust fund would not have a cost to the system<sup>10</sup> under current actuarial assumptions. There is, however, a potential risk to the fund if those assumptions change or actual experience falls below assumed levels. When an annuity is purchased, the member locks in the actuarial assumptions in place at that time. A subsequent change in assumptions may knock the annuity out of actuarial equivalency.

For instance, the Actuary’s 2010 fiscal note assumed a trust fund annuity would be calculated using the fund’s 8% interest assumption. The Board has since reduced that assumption to 7.5%. An annuity locked in with an 8% interest assumption would be “too high” under a 7.5% assumption, causing a \$12,980 actuarial loss to the fund<sup>9</sup>.

### **Roth Contributions**

The original 457 plan design allows employees to deduct contributions from their salary pre-tax. The amounts are taxed at the time of distribution. A Roth<sup>11</sup> plan reverses that system by taxing contributions, but then disbursing contributions and earnings tax free after retirement.

Governmental 457 plans were not originally allowed to offer a Roth option. The Small Business Jobs Act of 2010 authorizes government sponsored 457 plans to offer designated Roth accounts. Federal law now allows governmental 457 plans to permit participants to:

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<sup>10</sup> See OSA fiscal note on 2010 annuity purchase proposal, Appendix C.

<sup>11</sup> Named after Senator William Roth of Delaware, the chief legislative sponsor of the original legislation in the Taxpayer Relief Act of 1997 (Public Law 105-34).

- Designate a Roth elective deferral account within the plan; and/or
- Convert conventional pre-tax contributions into Roth contributions within the same plan. Participants wishing to convert existing contributions would have to pay taxes on amounts converted at the time of conversion.

Participants in DRS's 457(b) plans cannot take advantage of in-plan conversions/rollovers to designated Roth accounts unless DRS formally adopts those options in their plan document. DRS has the authority to do this under current law, though they are not required to.

## **POLICY OPTIONS**

The specifics of options available to the Board are in many ways a function of federal tax laws. DRS has received some guidance from the law firm of Ice Miller as of this writing. The LEOFF Plan 2 Board staff had additional questions which are still pending at this time. The options presented below, while accurate in broad strokes, may have to be modified in subsequent presentations depending on future tax law guidance. Additionally, option 1 could be combined with either option 2 or option 3.

### **Option 1: Propose Legislation authorizing LEOFF Plan 2 to accept roll-overs of tax deferred savings and annuitize those amounts through the plan upon retirement.**

Under this option the Board would direct staff to develop legislation authorizing DRS to accept roll-overs from LEOFF Plan 2 members for annuitization at the time of retirement. Further guidance is required to determine what types of roll-overs are allowable under federal tax laws and what limitations, if any, there are on annuitization of rolled over amounts.

### **Option 2: Propose Legislation establishing a 410(a) savings plan within LEOFF 2 to accept contributions from LEOFF Plan 2 members.**

Under this option the Board would direct staff to develop legislation establishing a "sidecar" savings plan within LEOFF Plan 2 that could accept member contributions for distribution following retirement. Preliminary research indicates that this vehicle would be less flexible than a 457 plan such as that administered by DRS's Deferred Compensation Program. Member contributions may be required to follow the same rules as Plan 3 contributions. A member could be required to select a rate upon enrollment. Like the Plan 3 contribution rates, once selected the rate could not be changed except upon change of employment. Voluntary member contributions, which could apparently fluctuate, would be after-tax.

**Option 3: Require LEOFF Employers to Offer DRS’s Deferred Compensation Program to LEOFF Members.**

This option provides a more flexible plan than the 401(a) option. The Board would propose legislation requiring all LEOFF Plan 2 employers to offer the state administered 457 plan. This would ensure that LEOFF Plan 2 members can avail themselves of a plan with the lowest possible administrative fees.

**SUPPLEMENTAL POLICY OPTION INFORMATION**

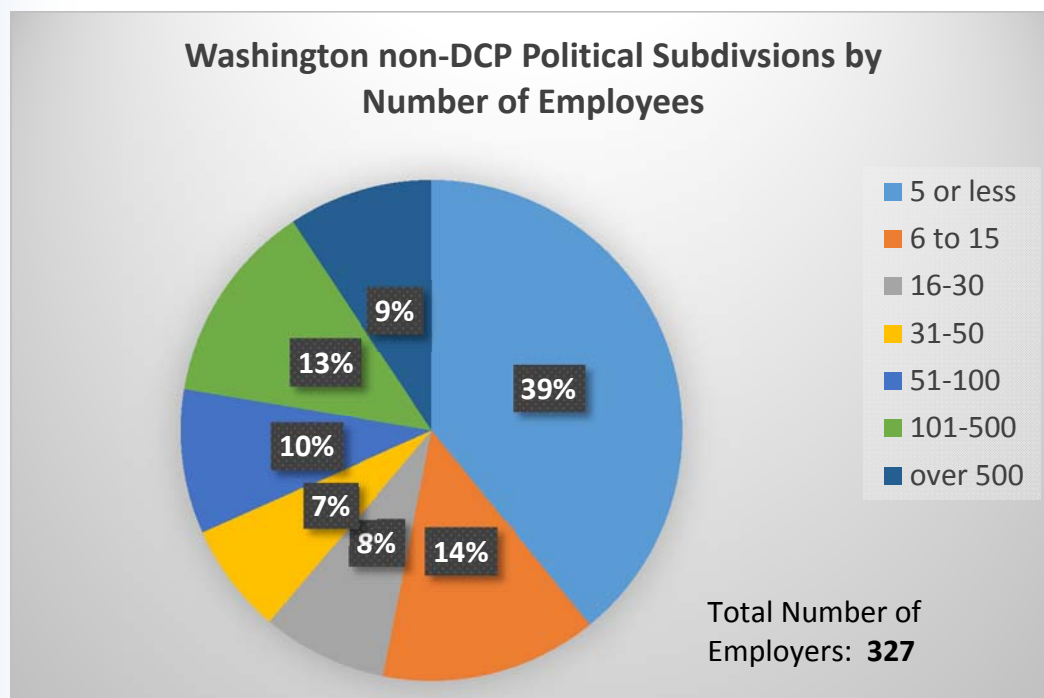
The Board requested additional consideration of options 1 and 3. A fourth option has been developed based on the additional information about Roth plans.

**Option 1:**

Staff has confirmed that the IRS will permit rollovers from any authorized tax-deferred savings plan (457, 403(b), 401(a)) into LEOFF 2 for purposes of purchasing an annuity. Further, there are no IRS limits on the amount that may be rolled over and annuitized, except that the total payout cannot exceed the IRS’s section 415 limits on maximum allowable benefit.

**Option 3:**

Staff has drafted proposed legislation that is currently being reviewed by DRS for comments. DRS Director Marcy Frost has asked the Select Committee on Pension Policy to consider a similar directive for all Washington Public Employers. Additional data from DRS identifies Washington political subdivision that do not offer the State administered 457 plan:



**Option 4: Roth Contributions to Governmental 457 plan.**

The Board may wish to take action on the Roth option:

**Option 4(a): Amend Deferred Compensation Statute to Require Roth Option.**

Submit legislation requiring DRS to develop a Roth option as part of its deferred compensation plan. The Board may want to direct staff to work with DRS on bill language.

**Option 4(b): Ask DRS to Offer a Roth Option**

If the Board wished DRS to develop a Roth option without a bill, it may be sufficient to send a letter from the Board to DRS requesting them to take action.

**Option 4(c): Take No Action at this Time**

The Board could decline to take any action on the Roth option at this time.

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## **SUPPORTING INFORMATION**

Appendix A: Deferred Compensation Fee Comparison

Appendix B: Plan 3 annuity purchase option features

Appendix C: Service Credit Purchase history and example

Appendix D: OSA draft fiscal note - 2009

Appendix E: Bill Draft re: annuitization of savings

Appendix F: Bill Draft re: Required participation in DRS 457 plan

Appendix G: Letter to DRS re: offering Roth option

Appendix H: OSA draft fiscal note -2013