DAVIS & HARMAN LLP

ATTORNEYS AT LAW

THE WILLARD
1455 PENNSYLVANIA AVENUE, NW, SUITE 1200
WASHINGTON, DC 20004

TEL 202-347-2230
FAX 202-393-3310 WWW.DAVIS-HARMAN.COM

April 15, 2015

VIA ELECTRONIC MAIL

The Honorable John Thune
United States Senate
511 Dirksen Senate Office Building
Washington, DC 20510
business@finance.senate.gov

The Honorable Ben Cardin
United States Senate
509 Hart Senate Office Building
Washington, DC 20510
business@finance.senate.gov

Re: Committee of Annuity Insurers Comments to the Business Income Tax Reform Working Group of the United States Senate Committee on Finance

Dear Chairmen Thune and Cardin:

On behalf of the Committee of Annuity Insurers,[1] we are writing in response to your invitation for comments to the Senate Finance Committee's Tax Reform Working Group on Business Income Tax. We would like to thank you, your colleagues, and your respective staffs for your efforts on this important topic. As part of those efforts, we encourage the Working Group to consider the valuable role that individual annuities and the life insurance companies that issue individual annuities serve in helping our nation's families prepare for and achieve a more financially secure retirement.

An individual annuity is an insurance contract issued by a life insurance company and used to accumulate retirement savings and provide retirement income. Individuals purchase these annuity contracts with after-tax money outside the context of any employer-sponsored retirement plan or IRA.[2] The current tax treatment of consumers who purchase individual annuities and the life insurance companies that issue them reflects long-standing and

[1] The Committee of Annuity Insurers (hereinafter, the "CAI") is a coalition of life insurance companies whose 29 members together represent over 80% of the annuity business in the United States. The CAI was formed in 1981 to address legislative and regulatory issues relevant to the annuity industry and to participate in the development of securities, banking, and tax policies regarding annuities. For more than three decades, the CAI has played a prominent role in shaping government and regulatory policies with respect to annuities, including working with both the Senate Finance Committee and the House Ways and Means Committee on the tax treatment of annuity contracts, the individuals who own them, and the life insurance companies that issue them. More information about the CAI, including a list of its member companies, can be found on the CAI's website at www.annuity-insurers.org.

[2] Employer-sponsored retirement plans and IRAs are generally considered "qualified" retirement arrangements for tax purposes. Because individual annuities are purchased outside any such arrangement, they are often called "non-qualified" annuities.

fundamental tax principles that properly tax income when realized. For consumers of individual annuities, this tax treatment not only reflects basic tax principles, but also a set of specific statutory rules that appropriately advance the societal goals of encouraging retirement savings and the use of insurance to protect against outliving those savings. Likewise, the current-law tax rules applicable to life insurance companies, the sole providers of commercial annuities, are grounded in basic tax principles as well as a carefully calibrated set of statutory rules. Those rules reflect the long duration of the risks insurance companies assume in issuing annuity products and the regulatory regime under which they operate, all in order to properly ensure that companies are taxed only on their current economic income. In short, the current-law rules accurately reflect income for purchasers and issuers alike, so there is no need to alter either set of rules as part of any efforts on tax reform.

As discussed below, changes to the tax treatment of individual annuities that make them less attractive to individuals preparing for and entering retirement would inevitably undercut Congressional efforts to facilitate retirement security for all Americans. Likewise, it is important to evaluate any proposals to change the taxation of life insurance companies from the perspective of whether those changes could reduce the availability of individual annuities in the market and / or increase the cost of individual annuities to consumers.

Our remaining comments focus on the following key points regarding individual annuities:

- Individual annuities provide a critical benefit to individuals preparing for and living in retirement because they can guarantee a stream of income that will continue as long as the owner lives or as long as the owner and his or her spouse live.

- Individual annuities are owned by middle-income families who use their annuities to accumulate retirement savings and provide retirement income.

- Congress thoroughly considered the federal income taxation of individual annuities in the years leading up to the Tax Reform Act of 1986 and carefully crafted a set of rules that continue to assure that individual annuities are used for retirement savings and retirement income. In particular, under those rules:

    - Savings in an individual annuity grow tax-deferred, which helps the owner save more for retirement than if the growth was taxed each year; and

    - Distributions are taxed in a manner that discourages the use of individual annuities for non-retirement purposes.

Introduction

Today, an individual's retirement years can span a substantial period of time; Americans are living longer than ever before. In the early 1900's, life expectancies at birth were 58.3 years for women and 51.5 years for men. More than a century later, those figures today are 84 years for women and 80 years for men, and most demographers predict continued increases in life

expectancy going forward.[3] As a result of these increases in life expectancy, as well as other factors, Americans are now spending a greater proportion of their lifetimes in retirement than previous generations. Today, the average retiree can expect to spend approximately one-fourth of his or her life in retirement.[4] In addition, the 70-million-strong baby boom generation is rapidly joining the ranks of the retired, which means that many more Americans currently need or will soon need retirement income to support their basic needs and maintain a comfortable standard of living.

Since the second half of the twentieth century, the three key components of the American retirement system have been Social Security, employer-sponsored retirement plans, and private retirement savings. With respect to the first two of these components:

- *Social Security* currently replaces only about 40% of pre-retirement income, which is substantially lower than the 70-80% that many financial planners say is needed to maintain an individual's standard of living in retirement.[5] In addition, the Social Security income replacement rate is declining,[6] and the imminent retirement of the baby boom generation will only increase the growing strain on the program.

- *Employer-sponsored retirement plans* and individual retirement plans (IRAs) are currently the most attractive and effective private-sector means of helping Americans prepare for retirement. As a result, no legislative action should be taken that might detract from the continued success of these arrangements. Rather, Congress should endeavor to strengthen and improve them. One area that needs attention is the shift in recent years from defined benefit plans to defined contribution plans and the corresponding reduction in the amount of retirement benefits being paid in the form of guaranteed income for life.[7] We agree with the Department of Treasury and the Department of Labor that this is a serious problem that needs to be addressed in part by facilitating better access to, and use of, lifetime income options in defined contribution plans.[8] Of course, within the context of a defined contribution plan only annuities can provide insurance protection that guarantees a participant will not outlive his or her savings. This is because only annuities are backed by a life insurance company that is regulated by the states and licensed to provide insurance protection against longevity risk

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[3] Jeffrey R. Brown, *The New Retirement Challenge* (September 2004).

[4] *Id.*

[5] SOC. SEC. ADMIN., SSA PUBLICATION NO. 05-10035, RETIREMENT BENEFITS 8 (2015).

[6] *See* Barbara A. Butrica, Karen E. Smith, & Howard M. Iams, *This Is Not Your Parents' Retirement: Comparing Retirement Income Across Generations*, 72 Soc. Sec. Bull. 37, 54, No.1 (2012).

[7] Brown, *supra* note 3, at 6.

[8] *See* Department of the Treasury and Department of Labor, *Request for Information on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans*, 75 Fed. Reg. 5253 (Feb. 2, 2010) (seeking input on steps that could be taken to facilitate "access to, and use of, lifetime income or other arrangements designed to provide a stream of lifetime income after retirement" in light of "the continuing trend away from traditional defined benefit plans to 401(k) defined contribution plans …" under which employees are increasingly responsible "for ensuring that their savings last throughout their retirement years and, in many cases, the remaining lifetimes of their spouses and dependents.").

by pooling that risk and distributing it among the retiree population.[9] But even if significant progress is made to facilitate and encourage the use of annuities in defined contribution plans, that alone will not be enough to ensure retirement security for many Americans. For example, some workers, such as farmers or non-working spouses, typically do not have access to an employer-sponsored retirement plan.[10] Even those who do have access to and participate in an employer plan may need other sources of retirement savings and income to achieve financial security in retirement. After all, the components of the American retirement system are Social Security, employer-sponsored retirement plans, *and* private retirement savings. Individuals need all three legs of this "three-legged stool" to support them in retirement.

In short, Social Security benefits and employer-sponsored plans alone cannot supply the income needs of the millions of Americans who will be retiring in the coming years. Private retirement savings will need to remain a key component of the retirement security system. In addition, promoting personal retirement savings, such as through individual annuities, is critical to the financial health of the U.S. economy as a whole.[11] In that regard, long-run economic growth is fostered when Americans are encouraged to save, and in fact do save, for their retirement years.[12] Thus, tax policies that have a proven track record of encouraging individuals to accumulate sufficient savings for retirement, and to convert those savings into retirement income that cannot be outlived, are critical to our nation's future. An example of such a tax policy is the federal income tax treatment of individual annuities, *i.e.*, annuities that are purchased with after-tax money outside the context of any employer-sponsored retirement plan or IRA.[13]

Individual annuities serve a major role in helping millions of Americans prepare for and live in retirement. The median annual household income of individual annuity owners is $64,000, and 80% have total annual household incomes under $100,000. In other words,

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[9] "Longevity risk" is the financial risk that an individual will run out of savings in retirement because he or she lives longer than expected.

[10] *See, e.g.*, Craig Copeland, *Employment-Based Retirement Plan Participation: Geographic Differences and Trends*, 2013 (Employee Benefit Research Institute, Oct. 2014) ("Being nonwhite, younger, female, never married; having lower educational attainment, lower earnings, poorer health status, no health insurance through own employer; not working full time, full year, and working in service occupations or farming, fisheries, and forestry occupations were all associated with a lower level of participation in a retirement plan.").

[11] The life insurance industry is one of the largest investors in U.S. capital markets, with total financial assets in excess of $5 trillion at the end of 2013. *See* American Council of Life Insurers, Life Insurers Fact Book 2014, p. 13.

[12] Numerous studies make this point, but of particular interest here is M. BOSKIN, B. BERNHEIM, AND P. BAYER, THE ECONOMIC ROLE OF ANNUITIES (Catalyst Institute, March 1998) (available at www.annuity-insurers.org) (observing that "[s]aving is critical to the health of the U.S. economy," that "because of their unique characteristics, annuities provide a particularly appropriate focus for policies to encourage saving and promote retirement income security," and that "opportunities for tax deferral through annuities should be continued, as their elimination would fly in the face of efforts to stimulate saving.").

[13] BOSKIN ET AL., *supra* note 12, at 88 (noting that "[t]ax deferral within annuity contracts encourages saving by increasing the real economic rewards associated with this activity" and that "[p]rovisions for tax-deferred annuities also create incentives for the development of pro-saving institutions.").

individual annuities are used primarily by middle-class Americans. Those Americans purchase and use their individual annuities for retirement savings and income purposes. Almost 80% say they bought an individual annuity because they wanted a "long-term savings plan" and 84% say they intend to use their individual annuities "for retirement income." And while many Americans in general believe they are not financially prepared for retirement,[14] 88% of those who own individual annuities say that the statement "you have done a very good job of saving for retirement" describes them well. This is largely because they purchased individual annuities – 82% agree that their individual annuity is an important source of their retirement security, and 85% agree that owning an individual annuity makes them feel "more secure in times of financial uncertainty, such as during declines in the stock market."[15]

Clearly, then, individual annuities are a critical component of our nation's private retirement system. Millions of Americans rely upon them to help achieve financial security in retirement. The specific ways in which individual annuities do this are discussed in more detail below, followed by a discussion of why the current federal tax treatment of individual annuities promotes retirement security and should therefore be maintained.

How Annuities Facilitate Retirement Security

In broad terms, there are two phases of retirement planning: accumulation and decumulation. Prior to retirement, an individual must attempt to accumulate adequate savings. During retirement, an individual must draw down those savings over life without running out. Annuities are uniquely suited to help meet both these goals.

A "deferred annuity" has two phases that correspond to the two phases of retirement planning just described – an accumulation phase and a decumulation phase. During the accumulation phase, the owner contributes savings to the annuity contract and those savings grow with interest or earnings to generate an account value (often referred to as the "cash value" or the "cash surrender value"). During the decumulation phase, the owner can apply the account value to one of several payout options offered under the contract, such as monthly payments guaranteed to continue for at least the owner's life. A different type of annuity – called an immediate annuity – also can be purchased without an accumulation phase, facilitating the conversion of other sources of retirement savings into retirement income. The following discussion provides more detail on how the accumulation and decumulation features of annuities help ensure long-term financial security in retirement.

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[14] *See* Matthew Drinkwater and Cecilia Shiner, *Consumers' Retirement Perspectives Fourth Quarter 2012* (Life Insurance and Market Research Association 2013) (finding that 80% of workers believe they need to save more to be on track for retirement, only one in five workers is saving 10% or more of their annual income for retirement, and two-thirds of workers who are already saving at least 10% of their incomes admit they need to save more).

[15] The figures cited in this paragraph can be found in The Committee of Annuity Insurers, Survey of Owners of Individual Annuity Contracts (The Gallup Organization and Mathew Greenwald & Associates, 2013). A copy of the survey is available on the CAI's website, at http://www.annuity-insurers.org/who-owns-annuities.

Facilitating Retirement Savings

Americans face many financial risks in preparing for retirement. For example, they must determine how much they need to save over time in order to have a sufficient amount to live on for up to two or three decades in retirement. Critical to that effort is the long-term rate of return the individual is able to achieve on his or her savings. If the rate of return is insufficient to keep pace with inflation, the purchasing power of an individual's savings will be eroded over time, putting retirement security in real jeopardy. On the other hand, investments in equity securities or similar assets that can bring higher returns to help address inflation risk also bring with them exposure to market volatility and risk of loss. Deferred annuities in their various forms can help address all these risks. For example:

- *A deferred fixed annuity* provides an account value that is credited with interest at a guaranteed minimum rate. Additional interest may be credited based on the interest rate environment. Because principal and a minimum return are guaranteed, deferred fixed annuities are appropriate for individuals with lower tolerances for market volatility.

- *A deferred variable annuity* provides an account value that typically is invested in mutual funds or other securities and reflects the investment gains and losses on those assets. This provides access to equity-based returns, which generally present market risk but which may provide a better chance of keeping pace with (or outpacing) inflation over the long term. Many deferred variable annuities also offer a fixed account option that functions in the same way as a deferred fixed annuity, thereby providing an additional option for the owner as his or her tolerance for investment risk changes over time.

- *A deferred fixed indexed annuity* provides an account value in which principal is guaranteed, interest is credited at a guaranteed minimum rate, and additional interest is credited based on the positive performance of a market index, such as the S&P 500. This provides assurances against market losses but also access to equity-like returns that can help offset the erosive effects of inflation on retirement savings.

- *Tax deferred growth* of the savings that accumulate within an individual deferred annuity is key to the owner's retirement security. Tax deferral motivates and enables individuals to accumulate more savings and thus to be better prepared for retirement. In that regard, 70% of individual annuity owners say they have set aside more money for retirement than they would have if the tax advantages of their contracts were not available, and 90% say that keeping those advantages is a good way to encourage long-term savings.[16]

In addition to the foregoing basic types of annuities, the following features are available and, in many cases, common:

- *Flexible premiums* – Deferred annuities typically provide for flexible premium payments. This allows annuity owners to save for their retirement on a schedule and in an amount they choose and in a manner that is covered by insurance and investment guarantees.

[16] *Id.*

This flexibility encourages more savings by appealing to the needs and savings habits of a wider range of individuals, such as small business owners who have fluctuating income, women who tend to enter and exit the workforce over their lives, and individuals who only begin to save for retirement later in their working lives.

- *Investment risk protection* – Many deferred variable annuities offer optional benefits that can protect against market risk while still providing access to equity markets. For example, "guaranteed minimum accumulation benefits" guarantee a minimum rate of return before annuity payments commence, while still allowing the holder to participate in equity markets. Likewise, as discussed above, deferred fixed indexed annuities provide access to equity-based returns but limit exposure to downside market risk. These features encourage individuals to invest in assets that are more likely to produce returns that keep pace with (or outpace) inflation.

- *Death benefits* – Virtually all deferred annuities provide death benefits, and it is very common for those benefits to guarantee a return at least equal to the contributions made to the contract. In addition, optional "enhanced" death benefits are available that provide protection against market losses. These benefits indirectly facilitate a more financially secure retirement for annuity owners because they allow owners to invest in equity markets without fear of leaving dependents and other beneficiaries with inadequate assets should the owner die unexpectedly during a downturn in the financial markets.

Facilitating Retirement Income

As indicated above, accumulating retirement savings is only one half of the retirement security equation. The other half is making those savings last throughout retirement. Converting retirement savings into a sustainable stream of retirement income can be a daunting task for an individual to undertake without the right tools. In addition to uncertainty about future personal expenses, inflation, and asset returns, it is impossible for an individual to predict how long he or she will live and therefore how long his or her savings will need to last. As a general matter, individuals are living longer and spending more time in retirement than ever before, which could leave too many Americans with little or no income in the later years of retirement. This risk of guessing wrong about how long savings will need to last – longevity risk – is a risk that every retiree faces. And with 77 million baby boomers beginning to enter retirement, the societal need to help individuals address that risk is escalating.

Individual annuities, again, offer the ideal solution. Other than Social Security and employer-sponsored defined benefit plans, annuities are the only means that Americans have to *guarantee* they will not outlive their retirement income.[17] This type of insurance guarantee is becoming increasingly important in light of factors such as reduced coverage by employer-sponsored defined benefit plans. In addition, many individuals do not accumulate "retirement savings" *per se*. They may own a small business or farm, a home, or receive a modest inheritance or divorce settlement. Others may have funds set aside by a parent or other relative

[17] *See, generally,* J. BROWN, O. MITCHELL, J. POTERBA, AND M. WARSHAWSKY, THE ROLE OF ANNUITY MARKETS IN FINANCING RETIREMENT (MIT Press, 2001).

to cover their special needs in adulthood. A retiring small business owner, downsizing homeowner, or individual may receive a single sum of money at or near retirement age. In all of these common cases, the funds, no differently than retirement savings accumulated over time, must be converted into retirement income that the individual cannot outlive.

Absent such guaranteed lifetime retirement income, many Americans may run out of savings or face very difficult circumstances. On the other hand, retirees who receive guaranteed lifetime income from annuities are more likely to have an adequate standard of living, even if they live into their 90s or beyond; live more independently (and avoid becoming a burden on others); and have the peace of mind that guaranteed lifetime income can bring.

Annuities provide insurance protection against longevity risk by pooling that risk among a large group of individuals, so that no single individual bears the burden of the entire risk alone. These insurance contracts are available in a variety of forms that can be tailored to meet the individual's specific needs. For example:

- *Traditional fixed life-contingent annuities* provide regularly-scheduled periodic income payments that cannot be outlived. These payments can be obtained from an immediate annuity, where the annuity contract is purchased with a single premium and the periodic income payments commence shortly thereafter. Life-contingent annuity payments also can be obtained from a deferred annuity that has transitioned from its accumulation phase to its payout phase. In that regard, every deferred annuity includes guaranteed "annuity purchase rates," which is an insurance guarantee that each dollar of account value applied to a payment option will produce at least a specified dollar amount of periodic income payment for life. Typically, when the deferred annuity owner is ready to apply the account value to a payment option, the resulting payments will be calculated at the greater of the contract's guaranteed annuity purchase rates or the purchase rates the insurance company is currently offering.

- *Life-contingent variable annuities* protect against longevity risk as well as inflation risk by providing lifelong income and access to returns that have the potential to exceed the rate of inflation. Similarly, "guaranteed minimum income benefits" under variable annuities can provide lifetime income that is based at least in part on equity market returns while still providing a guaranteed floor, below which the periodic payments will not fall.

- *Guaranteed lifetime withdrawal benefits* also are available in many deferred annuity contracts. These benefits guarantee that each year of the owner's life a specified minimum amount will be available to withdraw from the annuity's account value, irrespective of how long the owner lives.[18] This allows individuals to maintain a liquid

[18] For example, the annuity contract may provide that the owner will be able to withdraw at least 4% of a specified "benefit base" each year for life. The benefit base could be the account value as of the date the owner first takes a withdrawal from the contract, the total premiums paid plus interest at a specified rate, or some other amount defined by the terms of the contract.

account value in their annuity and meet their current income needs, while also insuring them against the risk of outliving their retirement assets.

- *Longevity insurance* provides retired individuals an affordable way to protect against the risk of running out of income from their other retirement assets if they outlive their life expectancy. In general, a longevity insurance contract is an annuity which provides no cash value, provides a very limited death benefit (if any), and pays a stream of periodic payments for the individual's life (or the joint lives of the individual and a beneficiary) commencing late in life. As the Treasury Department has recognized, "purchasing longevity annuity contracts could help participants hedge the risk of drawing down their benefits too quickly and thereby outliving their retirement savings."[19]

As is evident from the foregoing summary, annuities often combine insurance against longevity risk with other "living benefits" that protect against additional financial risks that retirees face, including investment risk and inflation risk. In all their various forms, however, the key features of annuities that help mitigate the longevity risk individuals face are that they (1) provide a retirement income stream that is guaranteed to continue for life, and (2) are backed by a life insurance company that is regulated by the states and licensed to provide insurance protection against longevity risk by pooling that risk and distributing it among the retiree population.[20]

The Current Tax Treatment of Individual Annuities Promotes Their Use for Long-Term Retirement Purposes

The federal income tax rules that apply to individual annuities ensure that they are used for long-term retirement savings and retirement income. Since the inception of the modern individual income tax under the Revenue Act of 1913, amounts credited to an individual deferred annuity have not been taxed to the policyholder until he or she receives them. This treatment not only produces important societal benefits, but is also consistent with general income tax principles – taxpayers generally do not pay tax on income or gain that has not been realized. In addition, all growth in an annuity contract will be taxed when it is realized, *i.e.*, when it is distributed either during the owner's life or the lives of the contract beneficiaries after the owner's death.

Over the past three decades, Congress has enacted significant changes to the way individual deferred annuities are taxed to assure they are used for long-term retirement purposes. The changes have achieved Congress' purpose: individual deferred annuities are now widely used by middle-class Americans to save for their retirement income needs. In particular, the following tax rules applicable to individual annuities achieve that goal:

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[19] Longevity Annuity Contracts, 77 Fed. Reg. 5443, 5445 (proposed Feb. 3, 2012) (proposing regulations under section 401(a)(9) to facilitate the use of "qualifying longevity annuity contracts" in defined contribution plans and IRAs). The regulations have since been finalized. *See* 79 Fed. Reg. 37,633 (July 2, 2014).

[20] *See, e.g.*, KENNETH BLACK, JR. & HAROLD D. SKIPPER, JR., LIFE INSURANCE 162, 946-964 (13th ed. 2000) (summarizing the risk pooling attributes of annuities and the state regulation of annuities, respectively).

- *After tax premiums* – All contributions to an individual annuity must be made with money that has already been taxed; there is no deduction or exclusion from income for amounts contributed to an individual annuity.

- *Tax deferral* – Interest and other earnings in an individual deferred annuity generally are not taxed until distributed. Tax deferral enables individuals to accumulate more retirement savings and thus be better prepared for retirement. It also motivates them to save more for retirement. In that regard, as indicated above, 70% of individual annuity owners say they have set aside more money for retirement than they would have if the tax advantages of their contracts were not available, and 90% say that keeping those advantages is a good way to encourage long-term savings.[21]

- *Withdrawals* – All distributions from individual annuities other than periodic annuity payments are taxed using an "income-out-first" rule. This discourages owners from taking payments in a form other than periodic annuity payments, which are taxed using a *pro rata* basis recovery rule (see below). As indicated above, 88% of individual annuity owners say that the prospect of paying tax on money withdrawn from their contracts makes them try not to do so before they retire, which suggests that the current tax rules successfully encourage them to retain their savings until needed in retirement.[22]

- *Early withdrawal penalty* – A 10% penalty tax generally applies to withdrawals taken from an individual annuity before age 59½. Limited exceptions apply, *e.g.*, amounts received upon death or disability, and payments spread over life. Like the income-out-first ordering rule that applies to withdrawals, the penalty tax on early withdrawals encourages individual annuity owners to retain their savings until needed in retirement.

- *Annuity payments* – Periodic annuity payments (*e.g.*, monthly payments for life) are treated partly as a recovery of the after-tax premiums paid for the annuity and partly as taxable income. This treatment is more favorable than the treatment of withdrawals, described above, and encourages individuals to elect to receive periodic annuity payments under their annuity contracts, such as in the form of guaranteed life-contingent payments.

- *Ordinary income rates* – All income from an individual annuity is taxed at less favorable ordinary income rates, never capital gains rates, even if the annuity invests in mutual funds (the income from which otherwise would be subject to preferential capital gains rates).

- *Loans and gifts* – Any pledge, assignment, gift, or loan involving an individual annuity is treated as a withdrawal, taxed on an income-first basis, and unless an exception applies is also subject to a 10% penalty tax. This encourages the use of individual annuities to provide retirement savings and income to the owner and discourages other, non-retirement uses.

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[21] *See* Committee of Annuity Insurers, *supra* note 15.

[22] *Id.*

- *Ownership restrictions* – Only annuities owned by, or for the benefit of, individuals are eligible for tax deferral on the earnings credited to the contract. Limiting the tax benefits to individuals focuses annuities on retirement uses, as non-individuals obviously do not need to prepare for retirement and therefore do not need the same tax benefits as individuals in that regard.

- *Diversification* – Individual variable annuities, *i.e.*, annuities that invest in mutual funds, are subject to special Internal Revenue Code asset diversification rules. Those rules are designed to ensure that individual annuities are used to provide insurance protections and retirement income, rather than short-term tax deferral.

- *Required distributions* – After the owner's death, any remaining value in an individual annuity must be distributed and taxed under rules that substantially limit transfers of tax-deferred income (except to a surviving spouse). This imposes a limit on the length of time that the income tax due on the growth in an individual annuity can be deferred.

- *No basis step up* – Unlike other after-tax assets transferred by bequest, when an annuity owner dies the beneficiary does not receive a "step up" in tax basis and will be taxed at ordinary income tax rates, not capital gains rates, on all contract earnings when distributed.

Conclusion

Individual annuities serve an important role in helping Americans achieve a more financially secure retirement. The success of individual annuities in that regard is attributable in large part to their flexibility and their robust insurance features, which empower Americans to successfully address many of the risks they face in preparing for and living in retirement. Individual annuities also owe their success to the fact that Congress has fine-tuned their federal income tax treatment over the years to focus that treatment sharply on the goal of encouraging long-term retirement savings and retirement income. In light of this success, we are confident that the Working Group will agree that it is critical to the retirement security of American families that in making changes to improve our federal tax system, Congress avoid any changes to the current tax treatment of annuities and of life insurance companies that would reduce the availability of individual annuities in the market and / or increase the cost of individual annuities to consumers.

Again, we appreciate this opportunity to comment on behalf of the Committee of Annuity Insurers. If we can be of any further assistance to you or your staffs, please let us know.

Sincerely,

Joseph F. McKeever, III
jfmckeever@davis-harman.com

Bryan W. Keene
bwkeene@davis-harman.com

Mark E. Griffin
megriffin@davis-harman.com