By John R. Herron

Setting an income foundation with annuities

It's been said that no one retires with a pile of money, but with the expectation of an income from a pile of money. Annuities are contractually structured to distribute income for life, a benefit not available in income investments. Clients who seek tax-deferred accumulation without contribution limits, or a safe savings alternative, find that annuities provide compound interest and growth potential along with unique income benefits.

Once a deferred annuity's accumulation phase is complete, it provides a variety of income options that have value in both taxable and tax-qualified positions. One option converts an annuity policy from a cash value asset to mere cash flow through annuitization. Alternatively, the accumulated cash value of a deferred annuity can be exchanged for a new single premium immediate annuity (SPIA). For taxable nonqualified accounts, each of these methods is designed to reduce the income tax consequences of payments. They include an exclusion ratio, which provides a tax-free return of principal in each payment. Other payment methods, such as lifetime withdrawal benefit riders, can provide lifetime income along with the possibility of tax-advantaged cash flow, without relinquishing a capital asset.

Annuities also may be useful for clients who have low risk tolerances. Fixed annuities, in particular, serve as a low-risk savings diversifier. The exclusive advantage of deferred fixed annuities to earn interest that can't be lost after it's earned can drive safe capital accumulation, often at interest rates above current market yields.

The greatest disadvantage to annuity tax deferral may be its inevitable income tax reckoning, which must be considered in any design for future retirement cash flow. Annuities cannot escape income taxes on distributions without specialized tax or estate planning.

Income predictability

Income predictability is more important than ever before. The engine that drives annuity income is mortality credits, also known as "mortality yield." The premiums paid by annuitants who die earlier than others contribute to gains of the overall annuity pool, which provides a higher yield to survivors than could be achieved outside the pool.

In "Investing your Lump Sum at Retirement,"[1] Professors Babbel and Merrill studied annuity lifetime income. They pointed out that with traditional decumulation strategies, one must earn (or have enough money accumulated) to last an "entire possible lifetime," without knowing how long that will be. However, through the pooling effect of mortality credits, the income amount that an annuitant receives is instead based on their "expected lifetime," which can end up being a whole lot longer. The contractual income payment is based off a life expectancy table, and the payment keeps coming, no matter how long one lives. The predictability of that cash flow is a powerful planning advantage.

The use of either annuitization or a separate SPIA can substitute for a traditional pension plan, which is rarely available to workers these days. Handing over a lump sum in return for a specific amount of income over a lifetime—similar to a traditional pension plan—or a specific number of years, eliminates some risks of running out of cash flow. This income guarantee allows for other assets to remain invested for additional compounding, accumulation, and future income planning. Annuity income can also be structured to pay after the early death of an annuitant. Even with the full income taxation

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1. David F. Babbel and Craig B. Merrill, Wharton Financial Institutions Center Policy Brief: Personal Finance (2007).

of qualified annuities in IRAs, predictable annuity income has value.

Nonqualified annuity payments, as mentioned earlier, allow for access to a portion of tax-free return of principal in each payment, providing some relief from the income taxation of annuity income. Future income predictability can be further enhanced with a longevity annuity—also known as a deferred immediate annuity (DIA). These policies allow for the purchase of future income, based on "expected lifetime" at a future age. Using this type of annuity, a 55-year-old couple depositing $100,000 with one carrier can hypothetically secure a lifetime annual payment of $35,000 for both of their lives starting at age 85, including a return of premium feature in case of early death. This allows other assets to be spent earlier in retirement.

One last important element of income predictability is inflation protection, and most annuity plans provide for payment increases over time, at an additional cost, of course.

Income control

Generating retirement cash flow is complicated by income and capital gains taxes, required minimum distributions (RMDs), withdrawal rates, and sequences of market returns. Annuities allow for the control of income because they don't distribute any—until requested. Deferred annuities earn interest without any taxable income going into a client's pocket, providing a buildup of a tax-deferred capital base. Only through withdrawals, by annuitization, or other methods, does an annuity pay out any cash. From a planning perspective, this control provides wide flexibility in retirement income plans. It allows for the holder to tap different assets and accounts—tax-qualified or not, including annuities—to complement each other based on current income needs and market conditions. This control is valuable, considering the unpredictability that fluctuating dividends, capital gains, and bond maturities and calls may have on an income plan.

With 401(k)s, IRAs, and other retirement plans subject to RMDs, the above-mentioned 55-year-old couple with the DIA also gain a tax-advantaged element of control. By joining the DIA with a qualified longevity annuity contract (QLAC), federal tax code allows for the removal of those DIA assets from RMD calculations, subject to certain limits. The tax impact of RMDs can thus be reduced, especially when distributions are unnecessary, while the control of cash flow in later years is maintained.

The challenges of having enough retirement income to last a lifetime are daunting. Using even a modest annuity component in a retirement portfolio may provide a better overall income result. But it is important to understand the trade-offs annuities present regarding taxation, estate planning implications, liquidity, and flexibility over time. Still, with the right type of annuity, a strong foundation of income predictability and control can be laid for retirement income.

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