Receiving Retirement Income 4

While much of the focus on annuities in recent years has been on their value as a savings vehicle for retirement, their value as a source of lifetime income *during* retirement is equally important. Traditional sources of guaranteed retirement income are diminishing at the same time retirees are living longer, more active lives. This places the burden on individuals to both save carefully for retirement *and* wisely manage their investments during retirement so their money lasts as long as they live. How retirees decide to receive income from their annuities once they retire can play an important role in achieving this outcome.

Retirement Income Options

Once a person is ready to retire, annuities offer a number of retirement income options. The contract owner can choose to receive all the assets from the annuity at once, opt for a series of withdrawals of his or her choosing until all the assets are exhausted, or decide to exercise the annuitization features of the contract.

The following information pertains to non-qualified annuities that are purchased with after-tax dollars. While the payout options available are the same for annuities purchased as part of qualified retirement plans, as discussed in the last section of this chapter, the tax consequences are different.

Lump Sum Option

When a contract owner elects a lump sum distribution, the annuity is surrendered and all assets are withdrawn from the contract. Taxes will be due on earnings in the year the money is received and tax penalties may apply to withdrawals before age 59½. With this option, individuals are still faced with the need to generate a guaranteed stream of income.

Systematic Withdrawal Plan

With a systematic withdrawal plan, the assets are left in the annuity and the contract owner receives distributions at regular intervals until the assets have been exhausted or the contract owner elects to suspend the operation of the plan. All earnings on the investment are considered to be distributed before any return of principal and are taxed at ordinary income tax rates. Assets remaining in the annuity continue to grow tax deferred until withdrawn.

The principal advantages of a systematic withdrawal plan are the flexibility provided to the contract owner and the ability to maintain full ownership of the assets. The principal disadvantage is that the contract owner retains the risks associated with both uncertain longevity and investment fluctuations, particularly the exposure to adverse market performance during the early stages of retirement.

If a specified dollar amount is withdrawn each period, whether adjusted for inflation or not, the contract owner assumes the full risk of market cycles. The very principles that recommend dollar cost averaging as a successful strategy for entering the market, work against the contract owner in a liquidation strategy. Withdrawal of a fixed dollar amount means that a higher percentage of assets will be liquidated in a down market than in an up market. This can be a very dangerous strategy, even if long-term investment performance meets anticipated targets, since the withdrawal of assets in earlier years can prevent the overall portfolio from achieving the projected return.

The withdrawal of a specified percentage of assets rather than a specified dollar amount may help reduce this risk. Many people plan their retirement income based on an average rate of return on their investments (such as 8%). If they happen to retire during a time of far lower (or even negative) returns, however, the specified percentage of assets they withdraw may not provide sufficient income to maintain their desired lifestyle. To help reduce the impact of market fluctuations on retirement income, it is important for retirees to have a variety of diversified investments in their portfolios, including annuities which can help to create a guaranteed source of income that will last as long as they live.

Guaranteed Withdrawals

Contract owners electing a guaranteed minimum withdrawal benefit (GMWB) rider can choose to receive the value of their investment through annual withdrawals (up to a set percentage) until the entire amount is completely recovered. Contract owners electing a guaranteed lifetime withdrawal benefit (GLWB) can choose to withdraw a percentage of their contract value each year for as long as they live, regardless of market performance. All earnings on the investment are considered to be distributed before any return of principal and are taxed at ordinary income tax rates.

Contract owners electing these benefit riders have greater control over their assets, but may receive less on a monthly basis than if they annuitized. While some GLWBs are beginning to tailor the amount received to the age of the contract owner, only by annuitizing can an investor take advantage of the increased income that comes with risk pooling. (For more on the income advantages of risk pooling, see the chapter on *Annuities—An Overview*.)

Annuitization

Annuitization involves turning the contract owner's accumulated assets into a stream of income based on the amount of the contract, the annuitant's age, payout choices, etc. The insurance company guarantees that it will provide payments for the life of the annuitant(s). With a deferred annuity, money is saved and invested during the accumulation period, and then annuity payments are received during retirement. With an immediate annuity, payments begin immediately or within one year after the annuity is purchased. Payments can be either fixed or variable, and guaranteed for one person's life, for the lives of two people, or for a specific period of time.

Deferred Income Annuities

With a deferred income annuity (sometimes called "longevity insurance"), a retiree can purchase a contract at one point in time, for example at age 65, but defer payments until a later time, for example at age 85. Individuals not living until the commencement age will not receive benefits; and individuals that do live to the required age and beyond, will receive income payments. Because these products usually have no death or living benefits, and not all contract owners will live long enough to collect income, insurance companies can maximize insurance leveraging (risk pooling) and thus make larger income payments to retirees still living. Some newer versions do offer an optional death benefit as well as a joint and survivor benefit but are generally more expensive and offer smaller monthly payments.

Annuitizing a Portion of Retirement Assets

By exercising the annuitization option of a deferred annuity (or by purchasing an immediate annuity), the contract owner can transfer the longevity risk to the insurance company and, if a fixed annuity is chosen, the investment risk as well.

As mentioned in the chapter *Annuities—an Overview*, annuities are the only financial instruments available today, other than Social Security and pensions, that can guarantee a lifetime stream of income during retirement. Annuitizing a portion of retirement savings provides retirees with an effective hedge against outliving their assets. And because annuity owners are part of a mortality pool, the annuity payments received are larger than they could generate by saving on their own and systematically withdrawing funds in amounts that give them a reasonable assurance of not running out of money.

As part of a comprehensive retirement portfolio, annuities both reduce the risk of running out of money if a person lives a long life, and increase the amount of each income payment received.

Types of Annuity Payments

One of the first choices contract owners may have to make once they decide to annuitize is whether to receive fixed or variable payments. Owners of deferred fixed annuities can only elect a fixed payout option. Owners of deferred variable annuities, however, can sometimes choose either fixed or variable payouts. Once a selection is made, it is usually irreversible. With fixed payments, the insurance company sets a given amount it will pay (typically monthly) for the term of the contract. With variable payments, the amount of each payment is not guaranteed but changes with the performance of the underlying portfolio selected by the contract owner. Fluctuations in these payments can sometimes be reduced by opting for level payments (which hold payments level for a certain period of time) or stabilization guarantees (which provide a floor below which payments will not fall).

Annuity Payment Options

Another choice to be made when a contract is annuitized is the length of time payments are to be guaranteed.

Life Annuities

A life annuity provides an income stream guaranteed to last as long as the annuitant lives. Under a straight or pure life annuity, annuity payments stop when the annuitant dies. A joint and survivor annuity (often selected by couples) provides income for as long as either of the two annuitants is alive, although the amount of each payment is usually less than if the payment were based on a single life. A choice can be made to have payments stay the same or decrease after the death of the first annuitant. For example, under a joint and two-thirds annuity, each payment made after the death of the first annuitant is two-thirds of the amount paid while both annuitants were alive.

As discussed previously, a valuable feature of an annuity is the fact that it can generate higher income payments than an individual systematic withdrawal plan, and continue payments for as long as a person lives. But what about the investor that does not live long enough to receive many payments? There are a number of options for mitigating this risk. Each, however, results in a lower basic periodic payment.

Period Certain Annuities

With a period certain annuity, payments are guaranteed to continue for a specified time, for example ten years, no matter how long the annuitant lives. If the annuitant dies before the period has expired, payments continue to the designated beneficiaries for the remainder of the period. Period certain annuity payments typically are available for periods from five to 30 years.

Life Annuities With a Period Certain

Life annuities with a period certain option guarantee payments for the life of the annuitant, but also guarantee that these payments will continue for a set period of time if the annuitant dies before the period has expired. Payments continue to the designated beneficiaries until the guarantee period has ended.

Refund Annuities

With a pure life annuity, payments stop when the annuitant dies. In the most extreme case, an annuitant could die after one payment is made. Some annuitants prefer to hedge against this possibility by setting up a life annuity with some form of refund feature. As indicated earlier, such hedge provisions reduce the amount of the basic lifetime payments.

There are two types of refund annuities now being offered that pay a refund to the beneficiary if the annuitant dies before the total of the annuity payments received equals the premiums paid for the annuity.

- A *cash refund annuity* provides for a lump sum refund of the premium minus the annuity payments already made at the time of the annuitant's death.

- An *installment refund annuity* provides that payments will continue in installments until the amount received is equal to the premiums paid.

Risk Tolerance vs. Longevity

In deciding what type of annuity payment option to choose and how much to commit to it, individuals must determine their risk tolerance with respect to their possible longevity, as well as the relative importance to them of receiving lifetime income versus leaving money to their heirs. For individuals that live beyond their normal life expectancy, a life annuity will generate higher income but will lower the value of their residual estate.

Determining Variable Annuity Payments

The amount of each payment received from a fixed annuity is calculated at the time of annuitization and does not change during the life of the contract. The amount of each variable payment, on the other hand, fluctuates based on the investments chosen. Since the investment return of the portfolio cannot be determined in advance, some assumptions must be made in order to calculate the amount of the initial payment under the contract. This is accomplished by selecting an assumed interest rate or "AIR." After the initial payment, each subsequent payment is determined by adjusting the previous payment up or down based on the actual performance of the underlying portfolio for the period of time in question. If the portfolio earns more than the AIR, the subsequent payment will increase. If the portfolio earns less, the payment will decrease. If it earns the same amount, the payment will stay the same.

Some contracts set the AIR, but most allow the contract owner to choose from a range (usually 3-6%), the outside limits of which are set by state regulations. Selecting a low AIR will cause payments to increase faster with good performance, or decline more slowly with poor performance, than if a higher AIR were selected. However, the initial income payment will be less than if the higher AIR were selected.

Level Annuity Payments

Some variable annuity contracts provide payment streams that can be adjusted at periodic intervals of up to 12 months, rather than on a monthly basis, in order to provide the annuitant with an element of certainty. This allows the annuitant to plan on a given level of payments for the period in question. When the periodic adjustments are made, however, they are likely to be more substantial than if the adjustments had been calculated more frequently.

Payment Stabilization Guarantees

Other variable annuity contracts offer payments supported by "floors." These floors guarantee that subsequent payments will never be less than a given percentage of the original payment (e.g., 85% or 100%), regardless of the performance of the underlying portfolio. Some provisions limit the investment choices underlying the annuity, providing the insurance company with the opportunity to hedge its guarantee with derivative instruments. These floors provide contract owners with a safety net that may make them more comfortable with having their annuity payments subject to the variability of stock market performance. If a contract owner chooses this feature, however, payment amounts will be lower than if no floor were elected.

Liquidity Options

Historically, once any annuity contract had been annuitized, the stream of payments could not be altered. Some insurance companies have begun offering life annuities that allow annuitants that have also selected a period certain option, to receive an advance of a given percentage of income payments, subject to certain restrictions that vary by company. These partial commutations, as they are called, reduce the remaining annuity payments. Some companies also allow the liquidation of the entire annuity (commutation), converting the value of the future stream of income into a lump sum payment.

Taxation of Annuity Payments

If an annuity (fixed or variable) was purchased with non-qualified or after-tax dollars, a portion of each payment is considered to be a tax-free return of principal. The remainder of the payment is subject to taxation to the extent it represents earnings. Current federal income tax law specifies that the taxable portion of annuitized payments is taxed at ordinary income tax rates.

To determine the amount of each fixed annuity payment that qualifies as a tax-free return of principal, the insurance company makes an underlying calculation based on a formula known as the "exclusion ratio." For variable annuities, since the amount of each future payment is unknown, a different calculation is performed to determine the exclusion amount.

If an annuity was purchased with qualified or pre-tax dollars using funds from a 403(b), a 401(k), or an IRA (other than a Roth or an after-tax IRA), the full amount of each distribution is taxable at ordinary income tax rates, even the amount attributable to principal.

Qualified assets, once they have been annuitized, are not subject to the required minimum distribution rules of the Internal Revenue Code since the insurance company is deemed to have already made the appropriate calculation for a lifetime distribution of the underlying assets. (See the chapter on *Regulation and Taxation of Annuities* for more details on taxation.)