Annuities Offer Retirees Money like Clockwork

By Jack Zook, CPA, PFS

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The most pressing concern for many individuals approaching retirement is outliving their money. Over the past few years, this worry has been amplified by a volatile equities market, public debt default concerns, rising health care costs, and Social Security and Medicare sustainability.

One option that can provide certain clients with a degree of peace of mind is the annuity and its "guaranteed income"during retirement.[1]

This path, however, can be complex. Annuities are complicated contracts, and there are numerous types from which to choose. As reported in the June 20, 2011, edition of *Barron's*, there are about 1,600 types of annuity products.[2]

Variable annuities are regulated by the individual states and the Securities and Exchange Commission – and representatives selling variable annuities are typically regulated by the Financial Industry Regulatory Authority (FINRA) – but CPAs must still be well-versed in the distinctions among the products or be prepared to seek the advice of a trusted representative of annuity products when advising clients.

Normalized Income Stream

In a previous article,[3] I recommended a three-pronged approach to managing retirement fund distributions for clients. One of the three components, which is pertinent to this annuities topic, is the need to establish a normalized income stream to provide a basic level of funding to cover normal living expenses. To do so, each client's life expectancy and living expenses must be taken into account.

The Society of Actuaries finds that a 65-year-old male has a 25 percent chance of living to 92 (female to age 94) and a 10 percent chance of living to age 97 (female to age 99). Financial planners and advisors need to prepare their clients for the daunting task of funding, at retirement age, a full one-third of their expected total life span.

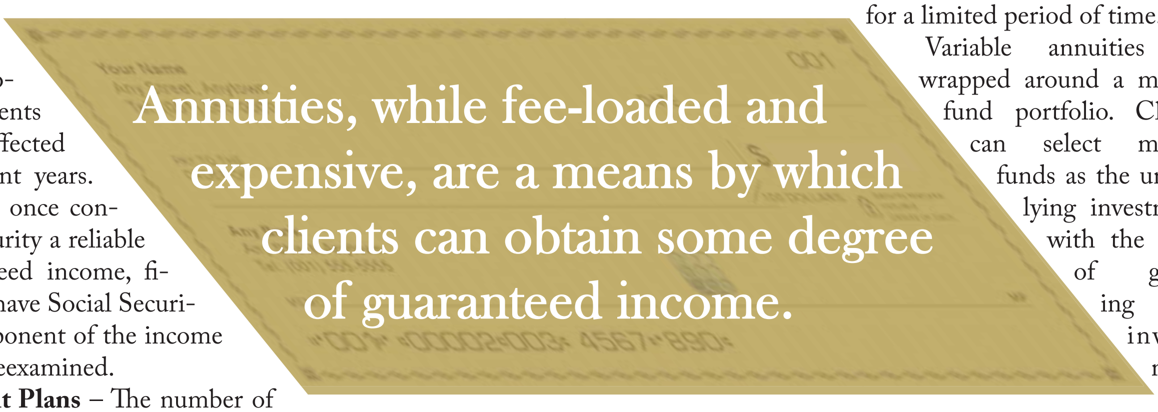
At the same time, advisors must work with their clients to determine what their normal living expenses would be in retirement. This estimate should, at a minimum, cover five to 10 years past the point of retirement. Inflation, changes in spending habits, and personal needs should all be considered. Escalation of health insurance costs and ▶

other medical outlays should be built into the equation.

Sources of Income

The need for stable, predictable sources of income will direct planners and clients to the options that will help clients meet their living expenses for their expected lifetime.

Social Security – A recently released 2012 annual report by the Social Security and Medicare boards of trustees indicates that the trust funds “cannot sustain projected long-run program costs under currently scheduled financing….”[4] Some Social Security recipients may be adversely affected in future retirement years. Since most clients once considered Social Security a reliable source of guaranteed income, financial plans that have Social Security as a prime component of the income stream should be reexamined.



Annuities, while fee-loaded and expensive, are a means by which clients can obtain some degree of guaranteed income.

Defined Benefit Plans – The number of defined benefit plans for nonpublic employees has greatly declined, removing the “guaranteed income” that earlier generations could rely on for their lifetimes. Today, mostly self-directed 401(k)s, 403(b)s, employer profit sharing plans, and individual retirement accounts (IRAs) have shifted lifetime income management and the related risks from the employer to the individual.

Reverse Mortgages – Home equity conversion mortgages (HECMs) have been receiving significant attention in recent years. When set up properly, this program can serve as a source of regular income, and those who choose this option can continue to live in their homes until they die or dispose of their properties. The decline in housing prices has adversely affected the funds available, but this option should still be considered.

Annuities – With annuities, clients invest cash with an insurance company or investment firm (the seller), and determine how much principal, and what return on that principal, they will receive, as well as for how many years they will receive it. The seller is in business to deliver that product at a profit, and will charge fees to provide that guaranteed income.

Annuities: A Closer Look

Annuities can be either immediate or deferred. Within each of those categories, there are fixed and variable annuities. There are many options to choose from, and each annuity contract contains its own terms, conditions, and fees, so prudent review is essential so you can help clients make an informed decision.

The immediate annuity (IA) is the simplest annuity product available. It essentially provides a personal pension plan on the spot. Once a client determines the amount of the investment they can make and the monthly payment they will receive for life, they write a check (after tax dollars, unless it is bought out of a deferred account) to the seller. They immediately begin to receive that guaranteed monthly income for life or some defined period.

Deferred annuities (DAs) have two phases in their life cycle: accumulation and distribution. A client will have the choice of taking the distribution as an annuity (annuitization) or as a withdrawal. The significant benefit of a deferred annuity is the tax-deferred accumulation and compounding of money prior to distribution.

Within these two basic structures, there can be many variations. The general differences would be fixed, variable, and equity index annuities.

The fixed annuity is a choice for risk-averse clients. The payout is fixed and depends upon interest rate conditions. Usually these products carry a guaranteed minimum rate of return that is stated in the contract, and some offer higher introductory rates of return for a limited period of time.

Variable annuities are wrapped around a mutual fund portfolio. Clients can select mutual funds as the underlying investment, with the hope of growing their investment through increases in the equity markets. The downside is the potential for decreases due to volatility in those markets. The client assumes the risk of managing the funds prior to either withdrawal or annuitization.

Equity index annuities are similar to the fixed annuity, but with the potential for greater rates of return and a guarantee on the contract owner’s investment. Generally, the return is set to the greater of minimum rate or increase in a specified index, such as the S&P 500.

Remember, there are no unconditional guarantees for any annuity product. A client can attain a level of comfort, however, by adding riders to annuity contracts that provide certain guarantees. When advising a client, know that all these guarantees have a price.

There are a number of guarantees available, but this article will focus on a few: the guaranteed minimum accumulation benefit (GMAB), the guaranteed minimum income benefit (GMIB), and the guaranteed minimum withdrawal benefit (GMWB). The only way to know exactly how each works is to read the details of each annuity contract. This can be time-consuming, but it is a necessary process.

The GMAB provides that an insurance company will offer principal protection for your client’s investment in the event of poor performance of the underlying investments.

The GMIB rider provides a floor or base (usually the initial investment) from which tax-deferred compounding, at a percentage set by the contract, occurs during the accumulation phase. At the end of the accumulation phase, if your client wishes to receive the guaranteed minimum income, he or she could annuitize the contract.

The GMWB rider may be the best guarantee feature offered. It provides guaranteed income (withdrawals) for life with the ability to access the funds if needed. This is significantly more flexible than GMIBs.

The GMWB rider guarantees payments that represent a percentage of the investment in the contract for life. These payments are deemed withdrawals. The insurance company guarantees that the income base in the contract will be there, regardless of market performance.

Guarantees, of course, have their price. When evaluating specific products for your client, go to the respective seller's prospectus, which will detail all associated fees. The major criticism of variable annuities is the accumulated fees and their impact on the rate of return on the investment.

Factors to Consider

Given the extensive number of annuity iterations available, there is not enough space here to cover all possible scenarios. However, this section covers some of the major factors to consider when advising clients on annuity products:

Suitability – Annuities are not for everyone. Clients who might need them the most are usually those who are not sophisticated in managing investments, are undisciplined in financial matters, and are in need of a source of guaranteed income not provided elsewhere. In all cases, remember that suitability includes using a limited portion of a client's portfolio for annuity purchases. In May 2012, FINRA issued Regulatory Notice 12-25, which provides guidance on the suitability rule, FINRA Rule 2111.[5] This is an excellent resource for CPAs providing due diligence on client investment recommendations.

Death Benefits – For life-only immediate annuities, all is lost once an annuitant dies. Given that sobering fact, clients that choose immediate annuities should consider either a joint life payout or a life payout with a period certain. Upon death, the spouse or designated beneficiary continues to receive payments until the term ends. With a deferred variable annuity, the death benefit during the accumulation phase is generally the greater of the original deposit or the actual market value. During the distribution phase, most contracts will have continuing payments to a designated beneficiary. This is a critical part of the annuity contract review process that could have significant adverse implications to your client and his or her beneficiaries if not properly addressed.

Liquidity – A major disadvantage of annuities is liquidity. Most deferred annuities have significant surrender charges – generally starting at 7 percent on a declining basis over a number of years – while allowing access to a percentage of funds. Review contract provisions to determine when and how funds can be accessed. The key, though, is that your clients should have sufficient alternative liquid resources if they are purchasing annuities.

Control – Control of annuitized funds is transferred to the insurance company. With immediate annuities, a client has no choice. With deferred annuities, a client may want to consider not annuitizing a contract, opting for the guaranteed minimum withdrawal benefit discussed previously.

Fees – The different options and guarantees available for annuities all have associated fees. These fees are the major criticism of annuities since they effectively reduce the rate of return. All insurance products, however, are not equal. Comparison shop with your client. You may want to "back test" these products against other investments to compare the effect of fees on rates of return. This is not an easy process, but it is vital to helping your client maximize returns relative to the cost.

Tax Planning – Whether an annuity is purchased with after-tax dollars or through a deferred account, the reported taxable income will be taxed at ordinary rates. Using mutual funds as an alternative investment to annuities may give your clients the potential of long-term capital gains rates. Upon death, the remainder of an annuity usually passes to the beneficiaries without the benefit of the "stepped-up basis," which may be the case with mutual funds.

Protection from Default – Consider the strength of the payer and what safety nets exist for considered annuity products. Specifically, assist your clients in evaluating the insurance company that will be issuing the annuity. Several websites can help in this process, including A.M. Best's Consumer Insurance Center (www.ambest.com) and Moody's (www.moodys.com). Each state has a guarantee association that provides limited assistance to annuity policy holders in the event of a financial insolvency of an insurance company. Each state has different levels of coverage, but most provide a safety net of about $100,000. This coverage usually applies to "one life," regardless of the number of policies or contracts. Find details at the National Organization of Life & Health Insurance Guaranty Associations at www.nolhga.com.

Evaluation and Recommendations

The essence of financial planning is to provide clients with a financial comfort level, particularly as they enter retirement years. Annuities, while fee-loaded and expensive, are a means by which clients can obtain some degree of guaranteed income. The major criticism of annuities has always been the reduced rate of return due to the fee structure imposed. For some clients, however, we need to evaluate that point against the benefit of obtaining psychological comfort from receiving a "guaranteed monthly check."

In the end, only the clients – after full disclosure of all of the facts – can make an informed decision about annuities. The process will require extreme due diligence on the part of the CPA to make sure that these highly technical contracts are fully explored, explained, and understood.

[1] *"Guaranteed income," as used throughout this article, is qualified; any "guarantee" is predicated on an entity's claims-paying ability and capacity of the source. There is no unconditionally guaranteed product or source of guaranteed income.*

[2] *Hube, Karen, "Best Annuities,"* Barron's, *pp. 27-32 (June 20, 2011), http://online.barrons.com*

[3] *Zook, Jack, CPA, PFS, "Strong Plan and Distribution Strategy Will Enhance Your Clients' Retirement,"* Pennsylvania CPA Journal, *Volume 82, No. 4, pp. 22-25 (Winter 2012), http://www.picpa.org*

[4] *"A Summary of the 2012 Annual Reports: Social Security and Medicare Boards of Trustees," Social Security Online: Actuarial Publications, http://www.ssa.gov/oact/TRSUM/tr12summary.pdf (last modified June 4, 2012)*

[5] *"Suitability: Additional Guidance on FINRA's New Suitability Rule," FINRA Regulatory Notice No. 12-25 (May 2012), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p126431.pdf*

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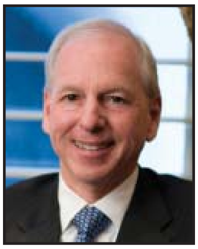

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