

Using Annuities to Provide Income

By Bob Affronti

The number one problem facing seniors today is the risk of outliving their money. Several factors affect the situation including longer lifespans, lower interest rates, and the terrible fact that too many seniors have lost too much money over the past few years due to the drop in the stock market. Many seniors still have enough assets to ensure a guaranteed lifetime income at levels that provide a decent standard of living — one, which they can't outlive. The solution, of course, is the lifetime annuity. Additional information and comments on the lifetime guarantee annuity will appear later in this article. I am a huge advocate of the lifetime guarantee, but today seniors are also faced with another financial issue — lower income from their investments.

If we look at a CD rate a few years ago, we find that a \$100,000 CD might have generated an income of about \$400 per month. The total amount of income would be taxable (assuming non-qualified funds). A 20% taxpayer would net \$320 per month after tax. That same \$100,000 CD today may generate about \$150 per month or \$120 per month after taxes. The traditional CD investor is now looking for alternatives to increase income. If you listen to people who ask the tellers at your bank what the current CD rates are, you will hear the moans and groans about how those low rates hurt their lifestyle.

Using fixed annuities to generate income can be done with three basic methods. The decision on which method to use is based on the desire to retain the principal, the amount of income desired, or the tax treatment on the income.

The bottom line is that you can double or triple the client's income by switching to a fixed annuity income method. Many investors and agents, for that matter, misunderstand the options that fixed annuities provide. I have previously written about the myths of single premium immediate annuities. Many seniors will not use the principal under any circumstances, saying "I am leaving this to my heirs." This does not preclude the use of fixed annuities to generate income.

Here are two ways to generate an income from a fixed annuity without losing the original principal:

Use a deferred annuity with a systematic withdrawal of interest — By using this method we are simply comparing the annuity rate against the CD rate. In today's interest-rate environment, fixed annuity rates on short term five years or less guarantees are up to 2% high-

er than CD rates. A person with a \$100,000 CD would receive an income of perhaps \$235 per month, while the annuity holder would get perhaps \$395 per month. This is an increase of almost 70%. How many fixed income CD investors would not like to get a 70% raise?

With this method, both the CD and annuity income are fully taxable. Many seniors do not have a tax issue anymore, so this method works. In both cases, the principal value doesn't drop. The term of the annuity may be longer than the CD, which can be a positive factor if rates continue to fall or the client is happy with the annuity rate.

Use a split annuity. This method works better for investors who are concerned about reducing their taxes. A split annuity consists of two different annuities. One provides a guaranteed income for a fixed term and the second annuity guarantees that the original principal will be fully restored at the end of the fixed term.

The primary advantage to this approach is that the income would be received substantially tax-free (97% for five-year fixed term, 85% for a 10 year term). This method can produce a much higher after-tax return for clients in higher tax brackets. As of this writing, a five-year split annuity can provide a monthly income of \$365 per month (97% tax-free!)

Where's the catch? The deferred side has grown from \$79,000 back to the original \$100,000. This produces a deferred gain of \$21,000. At the end of the term, the client may choose to do another split. The tax-free side will not be 97% anymore, but closer to 80%. This is still better than paying tax on all the income.

Split annuities can have terms of three to 10 years although, with this low interest rate environment, they don't look good unless you go at least five years. It is also important to note that a split annuity can be created using two different companies — one to provide the best multi-year guarantee and the other to provide the best SPIA price (or benefit). Of course this will be the same company at certain times.

I don't believe that the use of one-year guarantee "trust me" renewal rate products is a good fit for the split annuity concept. At the end of the term, the only thing we can guarantee is that the original principal will be higher or lower than the end value of the deferred side.

If interest rates rise and the company fairly

raises its renewal rates, the end value may be higher than the original principal. If rates go down or the company fails to increase the renewal rates, the end result might be lower. My experience is that clients who are investing in this concept want it to be fully guaranteed. We can provide a guaranteed payment for a period of years and return 100% of the original principal — guaranteed. Clients like to hear this.

We have used an indexed annuity to fund the deferred side. It is not guaranteed, but has a substantial upside potential, which offsets the guaranteed deferred annuity. With rates as low as they are now, an EIA with a 3% minimum guarantee is not too far below a fully guaranteed multi-year product. To give up 100 to 150 bp for a larger upside potential may make sense based on the client's faith in future EIA results. In any event, it has a good risk/reward ratio. Presenting the EIA option is done after the fully guaranteed program is shown.

Lifetime Payout SPIA —

This approach is all about peace of mind. Agents should offer the lifetime annuity with a money-back guarantee (life with a refund). Clients respond quite well to the "money back guarantee" feature.

Payments on lifetime annuities are subject to a portion of each payment being received tax-free. The chart below gives some idea as to the portion of

each payment, which is tax-free.

Once the annuitant reaches the life expectancy, all future payments are fully taxable. Why? Because the entire original principal has been paid out. Future payments consist 100% of "earnings." If any other investment had been used, payments would have stopped. Because the insurance company guarantees lifetime payments, those payments will continue until death.

The SPIA provides an income stream that can't be outlived, which is a definite concern for many seniors. The fixed-income investors are looking for ways to increase their income safely. The fixed annuity is a great solution to their problem. □

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Male, Age Tax-Free Portion

60	53%
65	58%
70	62%
75	70%
80	75%
85	80%