Immediate Annuities—Things you MUST Know.

An immediate annuity is an investment in which you invest a certain sum and immediately start getting payments back, generally for life, but sometimes for a set period of time, or even a combination of the two. Payments may be a fixed amount or a varying amount, depending on the buyer's choice. They may also specify payments to a survivor or an estate on the owner's death.

When people retire with a pension, they get an annuity. These are usually fixed payments, but many government retirees have an inflation adjustment which makes them worth about 50% more. Before payments begin, the employee is required to make a choice between survivor alternatives varying from 100% to zero, the latter requiring written permission from the spouse.

Social Security is like an inflation adjusted immediate annuity. It is clearly the most economical annuity which is why it's worth the cost to start later than age 62 and get larger payments. Its survivor benefits are outstanding. Theoretically, Social Security should be the safest, but the recent economic connections bring this into question. Nevertheless, if the government defaults on Social Security payments because of poor economic conditions, the providers of commercial annuities are likely to be affected even more.

Payment continuity depends on the insurer's solvency, so it's important to check the issuer's rating. When I was first married I got a life insurance policy that accumulated savings on which you could borrow or use later to make the premium payments. That insurer failed many years later and was taken over by the state which severely limited what contract holders could get.

Time changes many things beyond what may happen to an insurer's rating. The amount I was insured for seemed large at the time. But after several decades of inflation, the amount looks miniscule in retrospect. That's true of fixed payment annuities too. For example, my fixed pension lost 30% of its value in just ten years.

That loss was nothing to what my father experienced over his long retirement. He lived to age 96 and went through the brutal inflationary period of the seventies. He had mostly fixed income investments, and though he was well enough off when he first retired, inflation treated those fixed payments brutally so we, his children, provided significant supplements so that he could continue to enjoy his activities and get good health care.

An immediate annuity is a bet that you will do better than the insurer expects. The insurer must make a profit off the average results of a large number of people. To be a winner, you have to live longer than the average, sometimes significantly longer. That's why it is important to compare competitive offerings.

Comparisons of the amount of the payments are easy. Some Web sites will do that for you. Just look at the difference in the amount of the promised payments. However, the decision of what kind of annuity you want requires a computer program to compare benefits over lifetimes of the owner and survivor by trying different death ages. The retirement and annuity programs on www.analyzenow.com are designed to make this easy for those with Excel on their computers because they show side-by-side comparisons—something few other retirement or annuity programs do. Otherwise, it's best to go to a certified financial planner—which may well be a good thing to do anyway when making an irreversible lifetime commitment.

There are so many different financial things that happen during retirement that it's important not to put all of your eggs in one basket. What may be an excellent choice for the economic or lifestyle conditions at 65 may turn out to be poor considering the economic conditions and life's intervening events by age 75. Things change. That's why I have only part of my fixed-income investments in immediate annuities and even then spread their purchases out over a number of years. In spite of having to pay significantly more, I bought inflation-adjusted immediate annuities which have turned out to be the right choice but would not have been had the CPI turned negative for a number of years.

Spreading out the purchases over a number of years has lots of advantages. The ones purchased later in life have larger payments because the insurer knows that it will have to make fewer payments. In a low interest rate environment like the present, delaying purchase for a few years may well increase the payments as well if prevailing interest rates increase. Insurers base their payment promises on what they believe will be future interest rates.

Taxes are really an important consideration. Payments from immediate annuities purchased within a qualified account like an IRA are taxed at ordinary income rates. These rates will change significantly over a lifetime.

Payments from an annuity bought from taxable accounts are taxed in a very strange way. The government assumes that you will get your investment paid back to you in a series of even payments over your life expectancy. If the insurer assumed you had a 20 year life expectancy that would mean that one-twentieth of your investment is deducted from each year's payments as non taxable. It's a return of principal, so a large part of each payment from a non qualified annuity is not taxed.

But surprise, surprise! If you win the bet with the insurer by living longer than the 20 years in this example, 100% of each payment is taxed. Now the insurer loses, but the IRS wins. This comes late in life when people have pretty much fixed their spending commitments and could find it difficult to come up with the sudden increase in income taxes due. In fact, they may end up with a penalty if they had failed to increase their withholding in anticipation of the change. Those with inflation-adjusted payments had reached the point where taxes on their payments were almost negligible, so they have an even bigger surprise.

In spite of this tax peculiarity, I think it's often wise to buy an inflation-adjusted immediate annuity with part of a retiree's investments. It's even better if bought within a qualified account which doesn't have the tax surprise at the end of the insurer's bet on life expectancy. Using qualified money for an immediate annuity also reduces the Required Minimum Distribution, RMD.

There is a way to approach the benefit of inflation indexing using fixed-payment annuities whether from a qualified or taxable account. It's not difficult. All you have to do is decide that you will only spend the amount of the after-tax payment multiplied by your age divided by 100. Then put the remaining part of that payment back into savings. That will build up your savings to help pay for inflation as you withdraw money later in life to supplement those fixed payments now worth much less in value.

Not spending all of the after-tax money from pensions and fixed-payment annuities is particularly important for those with little savings. Spending only a fraction equal to Age/100 of those payments is crucial to long-term well being. I see too many people who, relatively early In their retirement, have so little savings that they can hardly support future medical expenses much less cover any emergency for a large expenditure such as a new auto or a roof replacement or help for one of their children in desperate financial difficulties.

There are situations where putting most of retirement savings into an annuity (preferably split between several insurers) may be a great value, not necessarily financially, but emotionally. A surviving spouse may lack interest or capability for managing a retirement portfolio and its withdrawals. Some people feel much more comfortable getting a reliable monthly check than making a withdrawal from a diminishing bank account. It's so simple it doesn't require the support from a CFP or an accountant.

There's lots to think about when buying an immediate annuity and even more if payments are tied to investment values within the annuity—which brings up another whole set of risks requiring very careful review of the fine print in the contract, a contract written to benefit the insurer more than you.

Bud Hebeler
5-12-12
www.analyzenow.com