PAYOUT OPTIONS: AN OVERVIEW OF IMMEDIATE ANNUITIES

By Michael Leonetti

Many individuals would prefer to know that they have a fixed guaranteed monthly amount coming to them versus the risk of investing a lump sum themselves. In that case, the annuitization of a lump sum may prove beneficial.

Annuities in general, and the annuitization process, can be a very confusing subject. Yet it is important to have a basic understanding of the differences and, more importantly, the pros and cons of the immediate annuity, since it is a regular option available to those with retirement plans.

Additionally, a good understanding of the immediate annuity and how it works gives you a good understanding of the annuitization options available for variable and fixed deferred annuities.

Before we get into the primary issues surrounding the immediate annuity, it would be useful to review some of the general annuity categories in order to better understand the topic and clear up some of the confusion.

BASIC ANNUITY TYPES

Generally speaking, there are two basic annuity categories: deferred and immediate. A deferred annuity is an agreement whereby assets are invested and accumulated on a tax-deferred basis over an agreed-upon time period, at which time they are withdrawn. At the time of withdrawal, the accumulated assets can either be taken out in a lump sum or in the form of an immediate annuity, and the earnings on these contracts are included in one's gross income. These earnings are typically taxed on a last in/first out method (i.e., the earnings are withdrawn first before the principal) unless the contract is annuitized, whereby each withdrawal amount has a prorated portion of principal and interest paid out. [The taxation on annuity withdrawals can be different if the annuity is funding an IRA or qualified plan, in which case all monies withdrawn will be taxable in the year of the withdrawal.]

The deferred annuity generally has two different types: fixed and variable. A fixed annuity works by accumulating the earnings based on an interest rate credited by the underwriting company (usually an insurance carrier). You would typically receive an updated evaluation at least once a year showing what the new accumulation is in your contract.

The variable annuity is a much more complex vehicle. This contract contains various mutual funds, and often a fixed annuity option, as choices for investment within the annuity itself. Thus, one could invest in various mutual funds on a tax-deferred basis if using the variable annuity. However, it is important to consider all of the ramifications of this type of vehicle. For instance, you cannot deduct capital losses should they occur in your investments within the annuity contract; in addition, there are usually higher expense ratios with these vehicles.

An immediate annuity is very similar to the annuitization process that can be applied to the payout of a fixed or deferred annuity.

THE IMMEDIATE ANNUITY

When annuitizing any type of annuity contract, you are essentially choosing one of the distribution options. For example, if you had some type of deferred annuity that was accumulating monies and chose to lock into some type of

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guaranteed payment over a certain time period, you could do this by annuitizing the deferred annuity contract at payout. This means choosing one of the payout options selected. Some of the options typically seen are:

- Life only—Payout for the lifetime of the annuitant.
- Life and period certain—Payout for the lifetime of the recipient with a guaranteed minimum payout time period should death occur to the recipient, during which payouts would continue to beneficiaries.
- 100% joint and survivor—Payout of the exact same amount to the annuitant or the beneficiary for both of their lifetimes.
- Joint and 50% survivor—Payout of a fixed amount for the lifetime of the annuitant with a payout of half of this amount for the lifetime of the beneficiary upon the death of the recipient.

Additionally, there are numerous variations to the above. You could combine a joint and survivor option with a period certain option. Oftentimes there are other combinations of the above that might better suit your needs as a recipient of annuity proceeds.

Essentially, the immediate annuity is the act of selecting one of these types of options and applying it to a lump sum upon the initial availability of the lump sum. For example, a defined-benefit plan may offer a lump-sum option upon retirement, where an actuary can calculate the lump-sum equivalent to be paid to the recipient, or it can offer recipients a number of immediate annuity options, whereby the recipient would select some type of monthly income for life or a period certain based upon the options available.

Alternatively, you could simply come up with the lump sum yourself from personal savings, and go out and purchase an immediate annuity, in which case you could choose any annuitization option available under that immediate annuity contract.

WHEN TO ANNUITIZE

The question of when to annuitize is one of the most difficult questions to answer for most individuals. Additionally, there is no pat answer that could be applied to everyone. Each individual's situation is different and whether the annuitization option makes sense for an individual is a function of his own personal situation. However, there are a few general considerations and things to look at when considering whether or not to annuitize.

One's own peace of mind is a key consideration in trying to decide whether or not to annuitize. Many individuals would prefer to know that they have a fixed guaranteed monthly amount coming to them versus the risk of investing a lump sum themselves. In that case, the annuitization of a lump sum of proceeds may prove beneficial.

Also, if one does not have any further beneficiaries or heirs to worry about, an annuitization might make sense in that you might be able to maximize the income received and would not be concerned with leaving some type of lump sum to heirs at your death. From that statement you can see that the lifetime option with no further benefits paid to anyone else gives you the highest monthly income amount. The longer the time period and more beneficiaries that an annuity contract will pay to, the lower the guaranteed periodic amount paid out will be.

Another key number when comparing distribution options and trying to make a selection is what I call the calculation of the "equivalent rate of return." The equivalent rate of return is the annuitization payout amount as compared to what you could earn on a monthly basis if you invested those dollars and worked off the earnings while trying not to gradually deplete the principal. Obviously, if you can maintain your principal and receive a certain monthly income payment that is equal to the monthly payment to be received under an annuitization option, you are likely to select a lump-sum payout and invest the proceeds.

For example, if you have $1 million and know you can invest this for a 6% return, you will receive $60,000 per year and still be able to maintain the principal amount you started with. If an annuity company states that they will guarantee a payout of $60,000 per year based upon your $1 million contribution, the equivalent rate of return on this annuity contract is 6%. If they guarantee a payout of $80,000, the equivalent rate of return would be 8%. However, one must remember each annuity payment includes a distribution of principal and interest while the lump-sum investment maintains the principal and is only working off of the earnings.

Once again, typically speaking, if the equivalent rate of return on the annuity contract is not higher than the rate of return that can be earned on a lump sum, it is more often than not better to take the lump sum and invest it versus selecting an annuity option. However, there are other considerations as stated above that could cause one to select the immediate annuity option even if the equivalent rate of return is not significantly better.

CONCLUSION

Choosing an immediate annuity or an annuitization option should be done very carefully. Once locked in, it typically cannot be changed and, thus, we recommend you seek your own counsel and advice when trying to decide whether or not an immediate annuity or annuitization option is right for you. ✦