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Immediate Annuities' Allure

Submitted by Mark Fried on Wed, 04/18/2012 - 9:00am

An immediate annuity is a guaranteed income stream that you will never outlive. That sounds pretty attractive. It's a highly tax favored way of achieving a guaranteed income unaffected by outside forces like a declining economy.

Americans are living longer than ever. The idea of living a longer, healthier life appeals to all of us. But the danger is outliving your retirement savings. The crippling costs of health care and the constant rise of inflation compound this financial predicament.

How it works. With an immediate annuity, you give a large lump sum to an insurance company, known as a single premium. In exchange, you receive a monthly income for life.
Example: A 75-year-old male purchases a $100,000 annuity. Based on current interest rates and his life expectancy, he'll receive approximately $725 dollars a month, every month for the rest of his life. If he dies early, his beneficiaries receive the remaining value, less payments received.

This is called a *life income with lump sum refund* option.
If the cash refund option is not important to him, and maximum income is, he could have chosen the *life only*payout option, which would pay a monthly payment of even more, $900 per month.

There are other annuity products, most prominently the variable annuity. You contribute to it over time, as you would to an individual retirement account. It is invested in mutual funds and is tax-deferred. These instruments are often criticized, though, for their high fees.

Tax treatment. With an immediate annuity, a large percentage of the income is tax-free. Our 75-year-old loses only four cents on the dollar to taxes. This is because a large portion of income is considered a return of principle. An annuity differs from other retirement vehicles: Qualified funds such as IRAs and 401(k)s, which are generally taxable because

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By Larry Light, Editor-in-Chief

At AdviceIQ, we believe that everyone should have a financial advisor – a good one, vetted through our system to ensure that he or she has a clean background. Hiring an experienced, capable advisor gives you the services of someone who knows the landscape of investing and other necessary financial matters, such as the amount and type of insurance you should have, and how you should set up your estate.

these products represent pre-tax dollars.

Asset Protection – Medicaid. Using an immediate annuity to shelter assets is a popular planning technique. It places the assets you paid to buy the annuity outside the realm of “Medicaid spend-down” of their estates. With the spend-down maneuver, some elderly people deplete their savings to pay medical bills – and then can receive Medicaid, the federal health-care program for people with low incomes and few assets.

By purchasing an immediate annuity, you remove those funds from your estate, and thus can qualify for Medicaid. The program’s minimal requirements are very low and vary depending on
your state. A better alternative is proper estate planning.
Creditor protection is another sought-after benefit of an annuity. In most states, your policy’s cash value is exempt from attachment by creditors. This is especially relevant if you incur a disability that prevents you from working. Florida and New York offer some of the most favorable laws shielding an annuity from creditors.

Drawbacks. Purchasing a single-premium immediate annuity is a permanent decision that will last for the rest of your life. Their emphasis is on security, not maximum return. Expect fairly conservative returns that seldom exceed those of bonds.

The welcome stream of steady payments is vulnerable to inflation. This is the inherent problem with fixed income investments, in general, and for the most part can't be avoided without delving into equity-type investments.
If you select the *life only* income option and you die a month into the contract, the insurance company gets all your money—nothing goes to your heirs. On the other hand if you outlive the actuarial tables you've won.

Generally speaking, immediate annuities are irrevocable contracts. Once you purchase one, the immediate annuity it is non-refundable, you lose the liquidity and no longer have access to these funds, save for the introductory "free-look" period. An annuity is NOT suitable for individual investors with liquidity needs.

Should you wait? The older we get, the more our income needs increase. If you're in no rush and have no immediate need for income, it often pays to wait. The payment amount is based on life expectancy, so the older you get, the larger your income payments become. Also, keep in mind that payment amounts are based on current interest rates, which are still relatively low. Waiting just a few years can make a significant difference.

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