HOW A DEFERRED ANNUITY FITS INTO RETIREMENT INCOME PLANNING

Martin L. Hearn
Registered Representative
Hearn Wealth Management LLC

1661 International Drive, Suite 400, Memphs, Tn 38120
martin@hearnwm.com | 901.473.9379
www.hearnwm.com

When people's thoughts turn to worrying about retirement income late in life, the deferred annuity is a tool they should know about.

by John L. Olsen, CLU, ChFC

As financial professionals know, a key part of retirement planning is having a strong income strategy. One major consideration for clients is ensuring that they have enough money to last as long as they live.

In recent years, a new type of annuity was introduced that may fit into your clients' long-term retirement income planning strategy: The "deferred annuity," sometimes referred to as a "longevity annuity" or a "deferred income annuity (DIA). This type of annuity also borrows a key feature found in an immediate annuity."

A deferred annuity is one that delays payments until the buyer chooses to receive them, while providing an opportunity for growth of income during the deferral period. An immediate annuity usually begins paying out protected income within one year after the date of purchase, either for life or for a selected time period.

With a deferred income annuity, the buyer purchases the annuity in advance of the annuity starting date. This is the date on which the annuity owner receives his or her first payment from the annuity. Often, the purchase is many years in advance of the starting date, so payments won't begin until some point in the future. Like an immediate annuity, the amount of the income benefit is known at the time of purchase.

ASSURANCE MONEY WON'T RUN OUT

Because a deferred annuity protects a known income amount that generally starts later in life, it can provide assurance that owners will not run out of money if they live to a very old age.

A deferred annuity can provide a larger future income payment per dollar of premium paid than any other financial product because of the mortality credits used to determine the income. It's a real "bang for the buck." The longer the period from the purchase of the annuity to the start date—known as the deferral period—the larger the future income payment is. That's because the older age of the owners means they will have a shorter life expectancy and fewer years to receive payments.

PRE-TAX OR POST-TAX

There are two basic types of deferred annuities. A "non-qualified" deferred annuity is purchased outside of retirement plans. This type of annuity is funded with after-tax dollars, meaning the buyer already has paid taxes on the money before it goes into the annuity.

The other type, called a "qualified longevity annuity contract" (QLAC), is funded with pre-tax dollars and purchased with assets from an individual retirement account (IRA).

The two types, however, share many features:

- Both protect the amount of the future income.
- Both let the buyer choose the start date. The start date for a QLAC, however, must be no later than age 85.
- Both typically have no cash value that can be accessed or surrendered by the owner.
- Some may allow optional inflation protection but typically only for the payout period.
- Both can provide a lifetime income. Some may allow two lives covered but the two lives must be a married couple.

THE ABILITY TO PLAN FOR AN UNKNOWN

When talking with your clients about their overall retirement income plan, you'll want them to consider: 1) Making sure they have enough money for as long as they live, and 2) Making sure they can maintain their lifestyle throughout retirement.

You can explain to them that a deferred annuity, whether non-qualified or a QLAC, amounts to a stream of income that "turns on" on the start date the client chooses.

When the protections of this annuity are incorporated into a holistic retirement income plan, an important benefit can result.

As we know, the biggest problem with retirement income planning is that it involves several unknowns. For example, we cannot know:

- Future investment returns.
- The sequence in which those returns will occur, which has a profound effect on when the client could simply run out of money.
- The length of time over which income payments must continue because we don't know how long the client will live.

The interaction among these three unknowns makes projecting future income very challenging. When a deferred annuity is included in the planning mix, however, it essentially removes the unknown for that income stream.

If a deferred annuity is purchased to help satisfy income needs late in retirement, it can boost client confidence. Clients may be willing to be more aggressive with other invested assets knowing that they have protected income in their 80s and beyond.

More importantly, clients may be willing to spend a little more money in retirement than they otherwise would knowing their income is protected for life. To some, it's this behavioral benefit that is the most profound advantage to purchasing a deferred annuity. It allows retirees to have the confidence of knowing they will have income late in life.

QLAC: ACCOUNT BALANCE NOT SUBJECT TO RMD

Returning to QLACs, one of their biggest benefits is that the account balance is not subject to a Required Minimum Distribution (RMD)—ever. But, payments from QLACS are still considered fully taxable income. RMDs from qualified plans and traditional IRAs must, of course, still be taken each year. Thanks to the passage of the Secure Act, clients turning age 70 ½ after January 1, 2020, now have till the April following the year in which they turn age 72 to begin taking RMDs.

A RISK-MANAGEMENT TOOL

When speaking with your clients about their retirement income strategy, make sure they understand a deferred annuity is a tool help them manage their longevity risk. It's income insurance! That is, why not transfer the risk of outliving their retirement income to an insurer who is able to pool the risk and manage it in a very efficient manner?

Annuities are long-term investments designed for retirement purposes. The value of variable annuities is subject to market risk and will fluctuate. Product guarantees are subject to the claims-paying ability of the issuing insurance company.

Earnings, when withdrawn, are subject to federal and/or state income tax, including a 10% tax penalty for withdrawals before age 59½.

Some income guarantees offered with annuities take the form of optional riders and carry charges in addition to the fees and charges associated with annuity products.

There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. Investments in annuity contracts may not be suitable for all investors.

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Martin Hearn RFC Investment Advisor Representative DBA Hearn Wealth Management LLC