Dispelling the Myths About Single Premium Immediate Annuities

By Bob Affronti

As the head of a national marketing organization specializing in annuities, I spend a good part of my day speaking with agents around the country. When the topic is single premium immediate annuities (SPIAs), the agent's level of understanding drops as to where the SPIA fits. I would like to dispel certain myths regarding SPIA's and hopefully bring this product the respect it deserves. By having a good understanding of how SPIA's work and all the pay-out options available, agents can greatly increase their sales while providing clients with benefits they didn't realize were available to them.

A major feature of the SPIA is the exclusion ratio. Each payment from an SPIA is composed of principal and interest. The portion that represents the principal is excluded from taxation and is received tax-free. If a $1,000 per-month payment has an exclusion ratio of 65%, only $350 per month is subject to tax. A20% tax payor would pay just $70 per month in tax and receive $930 per month after tax.

This ratio goes to zero at the point of life expectancy and the entire amount becomes subject to tax. On the surface, this appears to be a negative event. However, the principal has been used up. All future payments are income and will continue for as long as the annuitant lives. Any other investment in which principal is exhausted would cease payments. The SPIAcontinues.

For baby boomers beginning to reach retirement age, a fresh look at the SPIAis in order. The SPIA comes in various forms. Following is a list of SPIA payout options available from most companies.

- **Life Only** — This will produce the largest amount of income, but payments stop at death.
- **Life with Period Certain**—Payout is made for life, but with some minimum number of years guaranteed (five to 50).
- **Life with Cash Refund** — It's a money-back guarantee annuity. Payout is made for life, but if death occurs before payments total at least the premium, a lump sum cash payment is made. For example, if $100,000 is invested and payments of $1,000 per month are made for five years (60 months) and the annuitant dies, the beneficiaries will receive a lump sum of $40,000.
- **Life with an Installment Refund** — This is another money-back guarantee annuity. It's the same as cash refund except the beneficiaries continue to receive the monthly income until the full premium is paid out. In the above example, there would be 40 more payments made monthly.
- **Joint and Survivor** — This payout option

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guarantees that payments will continue for the lives of both annuitants. Certain options can be added. This form is used primarily with married couples to provide income as long as either one is alive. Sometimes the benefit drops upon the death of the first or the primary annuitant. This option produces a higher initial benefit.

- **Period Certain Only** — This option provides a benefit for a certain period of time, typically three to 50 years with no life contingency involved.
- **COLA SPIA** — This is a life annuity with payments that increase or decrease by a set percentage each year. The initial benefit can be substantially lower than non-COLAannuities.

Myth #1: The greatest concern of senior citizens is safety.

While safety is certainly a concern, the actual answer is "outliving their money." This is an important concept for agents. Their senior clients are worried about having enough money to provide an income they can't outlive. The agent has a product, which will guarantee to solve the problem. How many times is such a perfect fit overlooked?

Myth #2: If I die, the insurance company keeps all the money.

The only time this is true is with the "life only" benefit. This payout ends upon death. It has the highest payout factors and can be a planning tool when the payout is used to fund life insurance. Upon death, the annuity ends, but the life insurance pays up.

I suggest that agents offer their clients a money-back guarantee SPIA. Basically, this is an SPIA with a refund option. If a client invests $100,000, the client is guaranteed to receive at least $100,000 back in payouts. Of course, if they live longer, the payout will be more.

Myth #3: Future guaranteed annuity payments would be decimated by inflation.

SPIAs can be purchased with an annual COLA. Payments can be increased by 3% to 5% or more compounded annually.

Myth #4: A mutual fund will out-perform an SPIA as a source of retirement income.

Amutual fund might out-perform the SPIA. I have no bias against mutual funds. I do feel that clients looking for retirement income should recognize and evaluate the risk/reward trade off. If a mutual fund is used to provide income, certain risks must be identified. The following example is one I have used in agent and client seminars. In looking at the SPIA/mutual fund comparison, we need to make certain assumptions. With the SPIA, a deposit of $100,000 for a 72-year-old male will be about $1,000 per month for life. To be fair to the mutual fund, I will assume an annual return of 10% each and every year except one year in which the fund will drop by 10%. (Some feel this is too generous to the fund.)

Basically, with the SPIA, the client receives $1,000 per month for life. If we start with $100,000 in the fund and withdraw $1,000 per month, we would use $12,000 in the first year. If we also lost 10% ($10,000) we would find a balance of $78,000 at the end of year one. The client has used 22% of their retirement savings in the first year. Even though the fund will now earn 10% per year forever, each withdrawal will further invade principal until it is all used up. The SPIA also invades principal each month, but once the client's principal is exhausted (determined by life expectancy), the insurance company will continue to make payments for the life of the client, no matter how many years the client lives.

The issue is whether the risk of running out of money in later years is a fair trade off to the reward of perhaps higher payments in the future. I would rather have deflated dollars than no dollars. I don't think most agents or clients have looked at the risk/reward equation in this way. Risk is fine as long as the client understands why they are taking that risk and what reward they can expect for that risk.

Myth #5: If an SPDA is annuitized, the company will waive surrender charges.

Before a client annuitizes internally, a comparison should be made. I have seen many situations where the client would be better off (i.e. getting a higher pay-out) by surrendering the SPDA(actually a 1035 exchange to an SPIA), paying the surrender charge, and buying the SPIA from a more competitive company. If the charge is 3%, but another SPIA carrier's rates are 7% better, it pays to exchange. The client's only concern if they want to annuitize, is how much the payments will be. The existing SPDA carrier will provide a quote and then we can shop the surrender value amount to get a competing quote. If the internal annuitization under the SPDAis better, the client will accept that approach. If not, they can do a 1035 to another SPIA.

Medicaid SPIA

In some situations, the purchase of a restricted SPIA can help an individual qualify for Medicaid assistance sooner, and potentially pass on a greater estate to their heirs at death. In effect, the assets placed in such an annuity are no longer considered as assets that must be "spent down" prior to Medicaid eligibility. At death, any remaining payments are paid to the beneficiary and may be shielded from Medicaid collection.

Split Annuity (Combo)

Avery useful approach is the split annuity. This structure is used to provide income for a period of years, generally 5-10 years, and a multiple year guarantee is used to get back the original principal in the same number of years. Many seniors have CD's on which they withdraw the interest each year. They want to leave the principal to their heirs. A split annuity can greatly increase the income side and still guarantee a return of principal at the end of the term. This idea works so well because most of the income is received tax-free based on the exclusion ratio and the growth side is helped by the deferral.

Deferred-Start SPIA

Sometimes clients want to start a payment stream at a certain time in the future. An SPIA can be purchased with a guaranteed payment stream that starts as far out as perhaps 20 years. This can be a valuable planning tool when a 60-year-old client wants $1,000 per month for life starting at his or her 65th birthday. An SPIA can guarantee the premium and the benefit.

Life Insurance and LTC Funding

More and more often, the SPIA is being used to fund the premiums on life and LTC policies. Funds in an SPDA can be exchanged to an SPIA and life insurance can be purchased to offset taxes on the built up gains.

I suggest that all agents become familiar with SPIA's and their possible uses. The key element is that all aspects carry the magic word — "guarantee." For conservative clients with income needs, a guarantee may be exactly what is desired. It's an income that can't be outlived. By shopping many carriers, agents can get their clients the best deals available. ❑

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