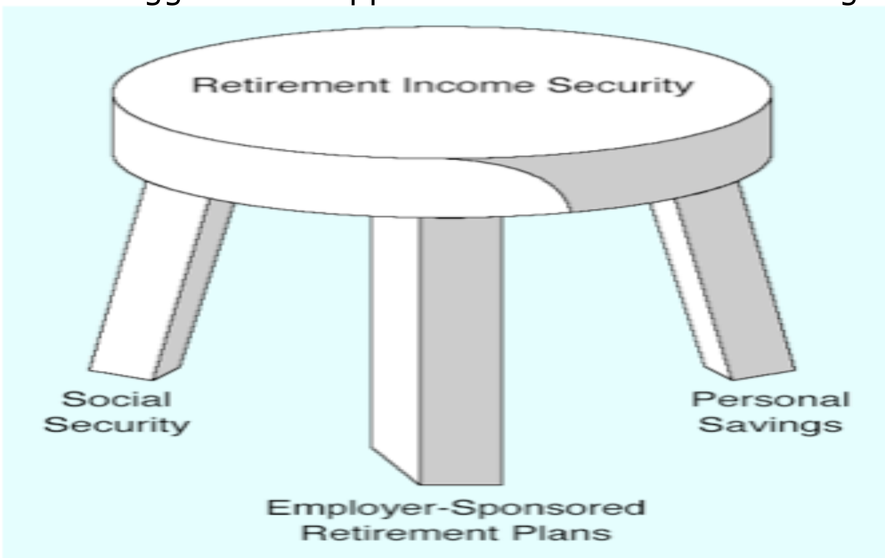
PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

CLASS NOTES

Chapter 19 Retirement Planning and Annuities

Three-Legged Stool Approach to Retirement Planning



- If investment earnings alone will not provide sufficient retirement income
  - Periodic withdrawals from the principal will be required
  - Under such circumstances, individuals living to advanced ages may outlive their income sources
    - Results in the need for a systematic means for liquidating resources
    - Together with a means for protecting against the risk of living beyond one's financial resources
      - A product that can be arranged to meet these needs is known as an annuity
- An annuity is a contract that provides for the liquidation of a sum of money through a series of payments during a specified period of time
  - Often the period coincides with the lifetime of one or more persons
  - The person receiving the payments (the annuitant) is protected against the risk of outliving his or her financial resources

Structure of Annuities

- Are structured so that annuitants' payments are composed of both interest earnings and a partial liquidation of principal
- For contracts guaranteeing payments for as long as an annuitant is alive
  - Each payment consists not only of interest and principal but also of a third element called the survivorship benefit

How are Annuity Premiums Paid?
- An annuity can be purchased with one lump-sum payment
  - Called a single-premium annuity

- Or it can be purchased in installments over a period of years
  - Called an annual-premium annuity
- Considerable latitude is allowed regarding the timing and amount of premiums
  - The installment arrangement is a flexible-premium annuity
  - The size of the eventual annuity benefit is a function of the accumulated premium dollars at the time the annuitant decides to begin collecting benefits
- Many of the life insurance settlement options discussed in Chapter 16 are, in essence, single-premium annuities
  - The life insurance proceeds are used as the single premium to purchase a particular income stream described in the policy

When Do Benefits Begin?

- Benefits can begin as soon as the annuity is purchased
  - And continue at specified intervals thereafter
    - Called an immediate annuity
- Deferred annuity
  - Benefits are deferred until some future time
  - The particular time when benefits are to begin may or may not be specified ahead of time
    - If such a time is designated, changes usually can be made if desired

Annuity Certain

- An annuity that is payable for a specified period of time
  - Without regard to the life or death of the annuitant
- For example, benefits might be payable for exactly ten years
  - If the annuitant dies before all payments have been made
    - The remaining benefits continue to be paid to either the annuitant's heirs or a secondary person named in the annuity contract
    - An annuity certain has no survivorship benefit
      - Payments consists entirely of interest earnings and liquidation of principal

Straight Life Annuity

- Pays benefits only during the lifetime of the annuitant
- If the annuitant dies the day after purchasing the annuity
  - There is no obligation for the insurer to return any of the purchase price
  - Rather, the money is used to provide the survivorship element of the payments made to those persons still living and collecting benefits
- The older an annuitant is when benefits begin under a straight life annuity
  - The greater is the size of each periodic payment
  - Older persons can be expected to die before collecting as many annuity payments as their younger counterparts

Temporary Life Annuity

- Rarely used
- Pays benefits until the expiration of a specified period of years or until the annuitant dies
    - Whichever comes first
- A temporary life annuity can be considered the opposite of a period-certain life annuity

Is the Contract Fixed or Variable?

- Fixed annuity
    - An annuity that has a benefit expressed in terms of a stated dollar amount based on a guaranteed rate of return
    - In practice, the actual benefit paid under a fixed annuity may vary over time
        - If interest earnings, expenses, and/or mortality experience are better than what was assumed in computing the annuity premium
- Market value-adjusted annuity
    - Sometimes referred to as the modified guaranteed annuity
    - Can be used with fixed deferred annuities to provide relatively higher minimal interest rate guarantees during the first several years after a contract is issued but before benefits begin

Is the Contract Fixed or Variable?

- Variable annuity
    - Benefit associated with a variable annuity is expressed in terms of annuity units
    - The value of each annuity unit fluctuates with the performance of a specified portfolio of investments
        - This causes the annuity income to fluctuate as well
    - General objective is to provide the annuitant with an income that fluctuates in dollar value
        - But remains reasonably constant in terms of purchasing power
        - To be successful, the investment portfolio underlying the variable annuity must increase in value when general price levels increase
            - In past years, variable annuities were invested almost exclusively in common stocks; however, today many different investment choices are available

Taxation of Annuity Benefits

- In determining the income tax payable on annuity benefits
    - It would be unfair to tax the entire amount of benefits paid
        - Because each payment consist partly of a return of an individual's principal

- The general approach currently required is to exclude a portion of each annuity payment from federal income taxes
  - Until the sum of all of the excluded amounts equals exactly the original purchase price of the annuity
    - After that time, the entire amount of each annuity payment becomes fully taxable

Taxation of Annuity Benefits

- The amount of each benefit that can be excluded from taxes is computed according to rules specified by the IRS
  - Publishes tables for use in computing the probable number of years that a person can be expected to live and thus continue to receive annuity benefits
- Exclusion ratio
  - Fraction of each payment that can be excluded from income taxation

Tax Issues Before Benefits Begin

- In recognition of their role as longer-term savings vehicles
  - Annuities usually do not produce taxable income for their owners until income benefits begin
- Some annuities are participating and may pay dividends to their owners
  - If the owner of a deferred annuity receives a dividend before benefits begin
    - The dividend is considered to be a return of premium and is not subject to income taxation
  - If the dividend is received after annuity benefits begin
    - Dividends serve to increase the size of the periodic benefit and are taxed accordingly
- One situation that may result in taxable income for an annuitant before benefits become payable
  - If the owner of a deferred annuity makes a partial withdrawal of funds
    - The withdrawal is treated as taxable income to the extent that the annuity value exceeds the total premiums paid
  - This rule was enacted to reduce the possibility that annuities might be used as short-term, temporary tax shelters
- The tax law also says for withdrawals that occur before age 59.5 a penalty tax of 10% may be added to the regular income tax payable on the withdrawal
- Withdrawals associated with some circumstances are exempt from the additional penalty tax
  - Such as death, disability, *etc*.
- The exemptions are few enough to cause many potential buyers of deferred annuities to think twice before committing the funds to such contracts at young ages
  - Unless an individual seriously intends to use the funds accumulating in a deferred annuity to help provide income during retirement
    - Alternative savings vehicles may be the better choice

End of Chapter.