Tax Season Food for Thought

MAKING PAYMENTS FROM AN INCOME ANNUITY FLEXIBLE OVER TIME

By Gary Baker

Once advisors get pulled into the world of retirement income planning, they quickly understand that managing a portfolio for sustainable cash flow can be significantly more challenging than supporting savings and asset growth. Fortunately, there are more retirement income tools, products and solutions available than ever before. Still, constructing a cash flow strategy is not a one-size fits all process and basically requires some customization for each client.

In that same vein, there's no single product (or silver bullet) that can solve all of the variables and changes that need to be effectively managed over the course of 20 to 30 years – or more – to support retirement income. This is why more financial planners are adopting product allocation concepts as a practice for cash flow strategies. These concepts essentially use both investment and insurance products (i.e., annuities) together to efficiently match assets to liabilities while also providing the opportunity to still grow with the market. In the financial planning community, income annuities have been positioned as a floor vehicle to support essential needs either for a period of time or throughout a lifetime in retirement. Advanced capital market concepts also position income annuities as a dynamic bond replacement within an investment portfolio to maximize both income and legacy needs.

When employing "investment plus insurance" concepts for retirement income, the investor will typically receive some form of systematic withdrawal from their investments while also receiving a separate check from the annuity – usually a fixed payout. As needs change over time, the withdrawals from investments could increase over time to compensate for inflation and rising medical expenses. However, there are also scenarios that may come into play where those withdrawals could decrease due to inheritance, lower income replacement due to aging, or various other time segmentation planning scenarios. So, how can an advisor make adjustments to a cash flow plan in the event supplemental income needs fall below the payout amount of an income annuity?

One advanced planning concept involves the use of qualified trusts or custodial accounts. Essentially, a non-qualified immediate income annuity is set up for the investor as the annuitant. However, the trust or custodian would be designated as owner of the contract for the benefit (FBO) of the investor/annuitant. The payments from the annuity would then be made to the non-natural owner (trust or custodian) and temporarily placed in a cash option within the account. Depending upon the structure of the account, the advisor can then manage (or automatically set up) a process where withdrawals are made from both the cash account, plus any other assets allocated among the other investments. If the withdrawal needs are less than the amount paid by the annuity, then the advisor would have the ability to periodically reallocate any unused annuity payout into the other assets within the account for market growth. A strategy like this would also allow the advisor to ensure that any unused income is protected and saved for future use rather than exposed to any potential impulse buying behavior by their client. You may laugh, but many advisors will share stories about how 99% of financial planning is really financial psychology support where they help prevent clients from making poor choices during retirement – where mistakes can have a more profound impact during retirement versus the savings and accumulation years.

The reason why this concept could be classified as advanced is because there's not yet any standard roadmap, process or common platform where this can be quickly set up and managed. With all the great potential embedded in a concept like this, there's some homework and set-up that would need to be done by the financial advisor before going live. Ultimately, it's up to a advisor or their firm to find the appropriate trust or custodian willing to take ownership of an annuity contract (not all do) and assess and lock down any potential tax implications with a local tax expert. Some scenarios that need to be considered when structuring such a strategy include:

Tax Reporting with the Custodian

Some coordination with the annuity provider may be necessary. First, tax reporting would be done at the account level where the valuation of the income annuity would be combined with the valuation of the other assets held in the account. Today, insurance carriers calculate a variety of different "present values" for annuitized contracts that can be provided to a custodian upon request.

Change of Ownership of Contract

If, for some reason, there's an issue with the custodian or trust that needs to be shut down, the contract would have to transfer to a new trust or custodian. It would be inappropriate to pull a non-qualified annuity contract out of a qualified setting without some means to convert the contract itself.

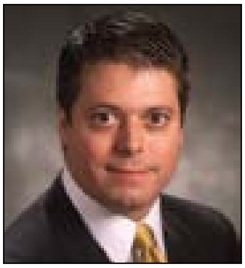
Death of the Annuitant

This should be straight-forward based on how the beneficiaries are set up for the contract. Depending upon the structure of the trust or custodian, this would need to be vetted.

If or when these processes are able to be defined and established locally, then the advisor would have a flexible platform which can be applied for a variety of cash flow and retirement planning needs.

Based on the experience of some advisors who have used this approach in the past, various scenarios include large allocations into the annuity to little amounts, use for younger investors (i.e., in their 40's or 50's) to much older, as well as deferring withdrawals for a number of years rather than taking them immediately. In today's market, the implied yield of a lifetime income annuity with 10-year certain for a 65-year-old is approximately 4% compared to the 10-Year Treasury or 10-Year CD at a bank which is hovering closer to 2%. In other words, the investor essentially gets the additional benefit of the mortality credit in addition to the interest and principal via the payout from the annuity which can then be reinvested within the account – a "super bond" if you will.

In summary, retirement income concepts and strategies have come a long way in a short period of time, however, the standard operational capabilities to efficiently and effectively support a number of these concepts still has a little ways to go. In the meantime, those advisors that incorporate and adapt strategies such as this one to their practice may have to set processes and structures up locally themselves. The result from this is a platform that an experienced advisor can more easily manage product allocation concepts like these that integrate the use of both investments and annuities. ■



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