Bridging Income with Annuities in Retirement

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Did you know that June is National Camping Month? Or National Accordion Awareness Month? National Cat Month?[1] No? Well, neither did I. But you should know that June is National Annuity Awareness Month, designated by the National Association for Fixed Annuities (NAFA). June is a noteworthy time to help educate your clients on the role annuities might play as part of their retirement income savings plan. Well-chosen annuities may offer payout options, accumulation benefits, and principal protection during the deferral period to help meet cash flow needs once your clients' salaries stop flowing into their bank accounts.

Changing Times

For many people, June is a month of transition. School ends, and parents seek summertime activities for their children. Employees plan summer vacations for recreation rather than occupation. And, of course, June traditionally is a month for weddings, marking the change from single to married life.

Those nearing retirement may be beyond some of these life events, but they're embarking on a transition of their own or will be soon. Regardless of the pandemic, today's life expectancy is greater than it was in the last century and probably will be greater in the future. The significant uncertainties retirees face include how long they will live and whether they will have enough income to support their lifestyle throughout their retirement. As priorities evolve from asset accumulation to guaranteed income, annuities can be a valuable supplement to anticipated revenue streams.

One way to ensure that retirees don't outlive their cash flow is to wait as long as possible before starting Social Security. Doing so will maximize delayed retirement credits, capped at 8% per 12 months of delay and stop at age 70.[2] Of course, the larger the initial monthly benefit, the larger all subsequent cost-of-living adjustments (COLAs) will be, providing the maximum benefit from Social Security for as long as the recipient lives.

For example, suppose Howard was born in 1960, so his full retirement age (FRA) is 67, five years from now.[3] Howard's my Social Security account estimates he will have a $2,000 monthly benefit by retiring at his FRA. Waiting until age 70 would increase that benefit by 24% ($480), to $2,480 a month, with no investment risk.

The risk is needing money before age 70 to pay the bills without Social Security benefits to help. Howard, in our example, does not want to work beyond age 62, his current age. If he starts Social Security, then his monthly benefit will be reduced by 30%: he'll receive $1,400 a month instead of $2,000 a month at FRA.

How can Howard afford to wait until age 70 for Social Security? One approach would be using an annuity to bridge the income gap. Howard might, for instance, consider purchasing an immediate annuity that will deliver inflation-adjusted payments for eight years, with another source of funds earmarked for retirement to allow his Social Security benefit to grow.

Once the annuity is all paid out, when Howard is 70, he can start collecting $2,480 a month, plus COLAs, for the rest of his life. Drawing down qualified or pre-tax IRA savings can be a valuable strategy to help lower his required minimum distributions at age 72. Plus, this strategy could help minimize the potential erosion of taxes on Social Security benefits in the future and perhaps help avoid a higher Medicare Part B premium caused by the Income Related Monthly Adjustment Amount (IRMAA) surcharge on high-income beneficiaries.[4]

The above example assumes Howard is single. In another scenario, Ivan and Joan are married, both approaching age 62. Ivan has a higher Social Security benefit, so he plans to wait until age 70 for Social Security. Joan will start to collect her own Social Security benefits at 62, bringing in some cash, but the couple will miss the money that Ivan won't collect for 8 years.

Perhaps in this example, a fixed index annuity that Ivan purchased by rolling a former employer's 401(k) into an IRA can help bridge income now, so the couple enjoys their retirement until Ivan starts Social Security at age 70.

Moreover, by waiting until age 70, Ivan guarantees a larger survivor benefit for the spouse who outlives the other. Maxing Social Security benefits for the widow or widower will be welcomed, as the survivor may face increased taxes after moving into a higher tax bracket and claiming a half-sized standard deduction.

Drawing down taxable accounts before starting Social Security can also be a viable option for funding an annuity bridge. With careful planning, some money might come from tapping cash reserves (which are not providing much income now). Some might come from liquidating losers (generating tax-favored capital losses). Others might come from realizing long-term capital gains (at favorable tax rates). Each approach (using immediate or deferred annuities and drawing down taxable accounts) might also work well in tandem.

Of course, annuities can also supplement Social Security while benefits are paid if there's a need for more income. Suppose Ken and Linda are both age 65 and want to receive $2,000 a month ($24,000 a year) on top of Social Security. They might spend around $500,000 upfront for an annuity that will pay $2,000 a month for as long as either one is alive (this example uses hypothetical numbers).

At $24,000 a year, it will take more than 20 years to get back their $500,000 outlay, but the annuity protects against asset depletion if one spouse lives well beyond 90 or even reaches 100.

Annuities come with various features, so a careful reading of the contract is vital. Matt and Nina, both age 60, also want $2,000 a month in addition to Social Security. Matt and Nina might choose a deferred income annuity instead of buying an immediate annuity like Ken and Linda because they are more concerned about income later in life. They could pay around $200,000 upfront but wait for 15 years, until they're 75, to start an income stream that will last as long as either is alive.

Annuity variations are virtually limitless. For example, the purchasers described above might pay a higher upfront premium for a cash-refund contract that will pay named beneficiaries any shortfall between the purchase price and the return of principal via monthly annuity payments.

Taxation of Annuities

As the above hypothetical examples illustrate, buying an annuity might involve a substantial amount for the upfront premium. Where will $50,000 or $100,000 or even $500,000 come from? Essentially, there are two choices: rollover or transfer a pre-tax retirement account such as a 401(k) or IRA or withdraw money from investment accounts holding after-tax dollars.

When the money invested in an annuity is qualified (a traditional IRA, for example), future withdrawals are taxed as ordinary income unless the annuity is a Roth IRA and meets the rules for a qualified distribution – then the distribution is tax-free.[5] Withdrawals are taxed under an exclusion ratio basis when an immediate annuity is funded with after-tax dollars. Essentially, a portion of each annuity payment is treated as a non-taxable return of the initial investment, and only the remaining portion is taxed as ordinary income.[6]

For example, in one of the above scenarios, Ken and Linda are both age 65. Suppose the actuaries at the insurance company from which they buy their non-qualified annuity calculates their joint life expectancy at 24 years—meaning the longer-living spouse is expected to receive annuity payments until age 89. The example indicated they would receive $2,000 a month—$24,000 a year—so the company expects to pay a total of $576,000 by the time the couple reaches their joint life expectancy.

Dividing the $500,000 premium by the $576,000 in assumed payouts equals 86.8%: the exclusion ratio in this example. Thus, 86.8% of every $24,000 in annual payments ($20,832) is treated as a tax-free return on their investment. Only $3,168 of that $24,000 (13.2%) is treated as taxable income for Ken and Linda.

This can go on for 24 years until the $500,000 that Ken and Linda invested in the annuity has been returned. If either spouse lives beyond those 24 years and continues to collect $2,000 monthly payments from the annuity, all of the post-age-89 annuity payments will be fully subject to income tax.

In addition to the favorable tax treatment of immediate annuities, non-qualified deferred annuities also offer control for tax planning purposes. Still, they do not receive the exclusion ratio treatment just discussed. Deferred annuities grow tax-deferred, which means the annuity owner can choose when to tap selected accounts to hold down taxable income during years in which other sources of taxable income are high.

However, unlike immediate annuities, withdrawals from deferred annuities are taxed on a last-in-first-out, or LIFO, basis. Any gain on the policy is withdrawn first before the initial premium or basis is recovered; this also includes annuities with income riders.[7]

A Surprise from the IRS Regarding Pre-59 ½ Withdrawals from Annuities

This month's focus is on using annuities as an income bridge for those in or nearing retirement. Annuities also may be helpful, in limited cases, in providing an income bridge to reach age 59-1/2, when the 10% additional tax on early withdrawals no longer applies on IRAs nor the gains on non-qualified annuities.

The latter type of income bridge gained appeal with a surprising development on January 18, 2022, when the IRS issued Notice 2022-6.[8] The notice could substantially enhance using a series of substantially equal periodic payments (SEPPs) as a strategy for individuals under age 59 ½. Moreover, the IRS stated that the benefits of this notice could apply for purposes of calculating SEPPs with non-qualified annuities under a similar section of code 72(q).

Historically, so-called 72(t) payments, most notably used in the qualified plan and IRA setting, have been used to avoid the 10% penalty. This safe harbor applies if the SEPPs are calculated using one of three IRS-approved methods. (Prior guidance was issued in Q-and-A 12 of IRS Notice 89-25 as well as in Revenue Ruling 2002-62, but Notice 2022-6 supersedes this guidance.)

For two of the three IRS-approved methods (fixed amortization and fixed annuitization), the maximum interest rate that could be used was 120% of the federal mid-term rate in either of the two months immediately preceding the commencement of payments. Currently, that rate is around 3%, but within the last 18 months, it has been as low as .62%.[9]

With interest rates relatively low, a larger pot of money is required to generate the income needed by the retirement account owner, leaving some early retirees with less income from their SEPPs than desired.

The new guidance in Notice 2022-6 redefines what the IRS considers a reasonable interest rate for the SEPP calculation. Beginning in 2022, taxpayers can use the greater of 120% of the federal mid-term rate or 5% in calculating SEPPs. For now, that means 5% is the rate to be used for SEPPs to collect the higher SEPP with the least amount of dollars needed if maximum penalty-free distributions are desired.

Although Notice 2022-6 may be welcome news in a low-interest-rate environment, it still comes with ordinary income tax on either the gain (non-qualified annuity) or on the entire distribution if on a Traditional IRA and a laundry list of dos and don'ts.

These distributions must continue for the longer of 5 years or until age 59 ½; any modification not caused by death, disability, or account depletion will cause a recapture of the 10% additional tax payments that were avoided, plus interest.

Fortunately, a one-time change from either the fixed amortization or the fixed annuitization method to the RMD method is not considered a SEPP modification. The same is true for switching to the new life expectancy tables for RMDs in 2022 or later years.

Any person considering adopting this strategy or any of the ones discussed here should consult their tax advisor before moving forward.

Sources:

[1]https://nationaldaycalendar.com/june-monthly-observations/

[2]https://www.ssa.gov/pubs/EN-05-10147.pdf

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[5]https://www.irs.gov/pub/irs-pdf/p590b.pdf Roth IRAs: What are Qualified Distributions? 2021 Returns

[6]https://www.annuity.org/annuities/taxation/exclusion-ratio/#

[7]https://www.immediateannuities.com/taxation-of-annuities/#

[8]https://www.irs.gov/pub/irs-drop/n-22-06.pdf

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