Deferred Income Annuities (“Longevity Annuities”)

The *deferred income annuity* (also called the “longevity annuity”) is a relatively new type of annuity contract, different from both the deferred and immediate types. Like an immediate annuity, it provides only a guaranteed stream of income for life or a certain period of time (or both) and typically has no account balance that may be accessed other than by annuitization. However, where income payout from an immediate annuity must commence within one year of purchase, the payout from a longevity annuity is generally not available until the annuity starting date chosen by the buyer, which may be many years after purchase.

# How Does a Deferred Income Annuity Work?

A deferred income annuity might be viewed as a hybrid of a deferred annuity and an immediate annuity. Like the former, it is purchased in advance of the annuity starting date—typically, well in advance—such that payments will not begin until many years into the future. Like an immediate annuity and unlike a deferred annuity, the original version of the deferred income annuity (often labelled the “longevity annuity”) typically offers no cash accumulation and exists only to provide an income benefit. The amount of that income benefit is a guaranteed amount at the time of purchase, payable either for a period of years or a certain period of time.

A typical version paying a stated income for life might specify that payments will not begin until the annuitant reaches the annuity starting age (usually an advanced age, often age eighty-five). If the annuitant dies before reaching the annuity starting date, the contract terminates without value. (It was this type in particular usually referred to when it first appeared as a *“longevity annuity.”*) If the annuitant dies after reaching the annuity

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starting date, the payments may stop immediately (if payments are purely life contingent) or may continue for some fixed period of time (if the annuity has a period certain payment feature) given that the annuity starting date had been reached. One contract, currently offered by a major U.S. insurer, requires annuitization only at age eighty-five or later and provides no death benefit or commutation feature.

The second type, which first appeared more recently, provides for some benefits even if death occurs before the annuity starting date—either a death benefit, a cash value, or both—and may allow the contract owner to make withdrawals prior to the annuity starting date, accelerate payments, or (rarely) commute remaining payments. For example, another contract, offered by that same insurer that provides the aforementioned “pure longevity” annuities, allows annuitization at the earlier of age fifty or two years after purchase, with a maximum annuitization age of age eighty-five (allowing the annuitization to occur anywhere in that time period). It includes a death benefit equal to premiums paid plus three percent interest if the investor dies prior to annuitization, and permits the investor to commute the annuity (to take a lump sum in lieu of remaining income payments) within sixty days following the annuity starting date. This *one time only* commutation feature is the onlyway in which the owner of this contract may liquidate it for a lump sum once purchased.

This latter type is often referred to as a *“deferred income annuity”* (although some commentators refer to both types as “longevity annuities” or both types as “deferred income annuities”). Some insurers offer both types of contracts. While most deferred income annuities are non-variable (“fixed”), at least one insurer offers a variable version.

Although there is still some variability by company, “pure” *longevity annuities* (the first contract type) typically permit only a single purchase payment while *deferred income annuities* (the second contract type) often permit ongoing premiums. In addition, while longevity annuities often (but not always) provide payments for life (but only for life), deferred income annuities often allow payouts either for life or for a specified period of years (Period Certain). In those contracts that allow ongoing premiums, each premium purchases a specified amount of guaranteed annual income to commence at the annuity starting date chosen by the buyer. As the amount of annual income purchased by a given premium will vary with the purchaser’s age, number of years before annuity

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starting date, and current interest rates, each annual premium will likely purchase a different annual annuity benefit, even if recurring premiums are identical. Until recently, few deferred income annuity contracts offered inflation protection. Currently, several carriers offer the option of level annual income payments or annually increasing payments. Typically, the amount of annual increase is chosen at the time of application and is a set percentage increase annually (usually, no more than six percent), but a few carriers offer annual increases tied to an external index, such as the Consumer Price Index. Notably, though, such increases generally do not apply *until* payments actually begin at the annuity starting date; as a result, there may be inflation protection beyond the point that payments begin, but not necessarily during the waiting/deferral period.

Death benefit, withdrawal, and commutation options are, as of December 2013, becoming more varied and more numerous, in much the same way that “guaranteed living benefit” riders on variable annuities proliferated a few years ago. Consumers are becoming more aware of the existence of deferred income annuities and financial advisors are, in the authors’ experience, increasingly more willing to consider incorporating these instruments into their clients’ financial plans. More insurance companies are offering deferred income annuities and sales have increased dramatically; for the first nine months of 2013, deferred income annuity sales grew 132 percent to $1.5 billion,[[1]](#endnote-1) although they are still a very small part of the overall market, with those nine months of sales representing less than one percent of just the fourth quarter, 2012, annuity sales.[[2]](#endnote-2)

Where does a deferred income annuity fit in the retirement income picture? A few years ago, one of the authors talked with several financial advisors, none of whom was familiar with deferred income annuities, about the “pure version” of longevity annuities. The almost unanimous opinion of these advisors, on first hearing of the general provisions of this type, was a mix of incredulity and distaste. “Why would anybody buy one of those?” was the consensus. Why, indeed? What’s it good for*?*

Milevsky calls a longevity annuity “a close relative of a defined benefit pension, and intended for those who don’t have one.”[[3]](#endnote-3) This is a vital observation that goes to the heart of the deferred income annuity concept. It’s allabout the assurance of a known level of income, starting in the investor’s old age—a *risk management* tool.Yet the advisors who view the fact that the annuity will terminate without value if the investor fails to live to age eighty-five as unacceptable are employing a very different mindset. They are applying investmentthinking to what is fundamentally a risk managementproblem. Milevsky speaks to this difference. “From a slightly different perspective,” he

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writes, “this type of product is akin to buying car, home or health insurance with a large deductible, which is also the optimal strategy—and common practice—when dealing with catastrophic risk.”[[4]](#endnote-4) Walter Updegrave, a senior editor at *Money* magazine, describes the longevity annuity in similar terms, observing that, “In effectit’s like buying a homeowners or health insurance policy that has a very large deductible. You're insuring yourself against a catastrophic risk you can’t handle on your own—in this case, running out of money late in life—while holding your premium to a minimum.”[[5]](#endnote-5)

Strictly speaking, the risk is not really running out of money at just any point in retirement. If there’s truly not enough money to support retirement, the annuity cannot create it out of thin air. The distinction, though, is that if a retiree is depleting funds because he is living beyond life expectancy and his anticipated retirement time horizon, an annuity—including a deferred income annuity—can provide outsized payments for those additional years beyond life expectancy, funded indirectly by the “mortality credits” that are generated under an annuity contract from those who did not live as long. Jason Scott, in his article *The Longevity Annuity: An Annuity for Everyone?,[[6]](#endnote-6)* distinguishes between funding a retirement income by saving(or investing) in a portfolio that will provide that income and purchasing insurancethat will do so. He makes the point that funding a retirement income portfolio with investment assets amounts to setting aside the full replacement cost of the income stream, which is essentially self insurance. He observes that “with self insurance, the money is set aside whether or not the insurance event occurs.” (Scott, *Ibid*) The longevity annuity—the insurance solution, if you will—differs in that the payout, or the benefit, is contingent upon the insured’s survival, without which the risk in question does not occur. In other words, if a retiree will need significantly higher than expected investment returns to provide income if he lives well beyond life expectancy, a longevity annuity is uniquely suited to provide those additional income payments through the morality credits that will apply in that situation.

In the conventional model of retirement income funding, we savefor an event—reaching late retirement age, when we’ll need the money—rather than insureagainst it. In this savings model, the money we save is ours, and is always available—either to us or to our heirs—whether the event for which we’re saving (reaching late retirement age) occurs or not, with the risk that if the unexpected event occurs—incredibly long life—we may find out after the fact that our expected retirement time horizon was incorrect and that our assets are depleting. When we purchase a pure longevity annuity, we invoke a different model. In this insurance model, we buy a contractthat will pay off only if the event insured against actually occurs: that we do, in fact, live to old age. It is this *contingency* of payoff that makes the longevity annuity so cost-effective.

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One problem with this two-model view is that it characterizes the investor during the savings period wholly as an accumulator*.* When we save for an event, the money we save is available to us, whether the event occurs or not, because it’s always been our money. When we insure against an event, we pay a premium to an insurance policy in exchange for a promise to pay us a much larger sum in the event that the event actually occurs. We do not accumulate that larger sum, because it is not ours until it is paid to us. If it is never paid to us, the insurance company uses the premiums we contributed to pay the claims for someone else in the pool, making the overall cost of pure protection lower for everyone involved. But our clients are not mere accumulators; they’re also consumers*.* They have lifestyles, and those lifestyles cost money. Accordingly, with a deferred income annuity, we can also take into account that certain asset allocation, income distributionstrategies, and spendingchoices could be attractive to an investor who is assured of a certain income on reaching the annuity starting age, but unattractive to an investor having no such assurance, who may otherwise need to create an additional reserve (save more money) against the potential of unexpected long life (or take the risk of depletion).

What lifestyle and investment choicesmay become available to our investor if she has an assurance that her retirement portfolio need not persist beyond age eighty-five because the deferred income annuity will take it from there?

This certainty—that once the investor reaches a certain age*,* the retirement income need willbe met (to the extent of the benefit purchased) for the rest of that investor’s life*—*totally reconfigures the retirement income planning problem. Without the longevity annuity in place, the problem is one of ensuring an adequate income over *an indefinite period*—a “longevity contingent” problem. With the longevity annuity, the period to be funded by withdrawals from a retirement portfolio is known in advance. It begins at the age of retirement and ends at the longevity annuity’s starting date—a “period certain” problem. These are not merely different scenarios; they are wholly different investment paradigms.

One might argue that there is another risk in play here. If one buys a pure longevity annuity and does not survive until benefits are payable, the purchase payment may be viewed as lost. But that is the same risk borne by anyone who purchases an automobile, medical expense, disability income, or term life insurance policy. If the insured peril does not occur, no benefit is payable. The purchaser, in that situation, will still have received value—the absolute assuranceof the specified benefit had the insured peril materialized.

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That said, some advisors will insist upon viewing the premium paid for a pure longevity annuity as a lossin the event of the insured’s death prior to annuitization. For this reason, some insurers offer contracts with a pre-annuitization death benefit. The cost of this benefit is the difference between the income guaranteed by that contract and the income guaranteed by the “pure longevity” variant. In any such product, this difference can be significant, and the greater the period between purchase and annuitization date, the greater the difference in the annual benefit provided by the two variants. If you require a refund of your investment if you don’t live to age eighty-five, for example, you’ll get lessincome when you reach that age then you would have if you hadn’t required that refund, and that income reduction will last as long as you do.

In the authors’ opinion, buying a longevity annuity with a pre-annuitization death benefit (the *deferred income annuity* type) is like buying term life or disability income insurance with a return of premium benefit. One is not only insuring againstthe occurrence of a specified peril (death or disability), but also insuringthe economic value of the premium payments themselves. By adding an ancillarybenefit, one reduces inexorably the leveragein the underlying insurance itself. To some purchasers and some advisors, this may make sense. To the authors, though, it is not prudent risk management. The purpose of insurance is to protect only against risks that the individual otherwise could not afford to manage without such protection. If the premium is so unaffordable that it would require its own insurance (just for the cost of the premium), it may be time to revisit the decision to purchase longevity, or any other kind, of insurance in the first place.

Another way of viewing the potential loss of premium would be to compare the current purchase of a pure longevity annuity with saving forthe purchase of an immediateannuity at the longevity annuity’s annuity starting date. The example below outlines one such comparison using one insurer’s rates as of December, 2013:

*Example:* A sixty-year-old male client can purchase a pure longevity annuity today for $100,000 and be assured of receiving $7,259 per month ($87,108 per year) for life upon reaching age eighty-five. An immediate annuity at today’s rates, paying $7,259 per month for life, for an eighty-five-year-old male, would cost roughly $585,000.[[7]](#endnote-7) What rate of return must we earn on the $100,000 we are considering using to buy the longevity annuity to produce $585,000—that will produce the same annual income as the annuity—in twenty-five years? The answer is 7.32 percent. (Taxes are ignored for simplicity.)

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What does this answer tell us? It *does not* tell us that the longevity annuity produces the same result we’d get if we were assured of earning that computed interest rate every year from investing that $100,000, because, in the “save for” scenario, the invested funds are ours. We can take that money at any time, or leave it to our heirs. The longevity annuity has no cash surrender value or, indeed, any value whatsoever unless and until we reach age eighty-five*.*

On the other hand, the goal—income for life, commencing at age eighty-five—is guaranteedin the annuity scenario. It is merely projectedin the “save for” scenario, and our projection makes two huge assumptions. First, that we will, in fact, earn the projected return each and every year. While that may be possible, in the case of the deferred income annuity it is effectively guaranteed (at least to the extent of the credit quality of the insurance company), and a 7.32 percent “guaranteed” fixed income return is arguably *quite* appealing relative to comparable market rates at the time this quote (and book) is being published. (And in general, the rate will always be appealing, as it represents a combination of both investment returns on the insurance company’s asset portfolio, and the accumulation of mortality credits for the survivor who reaches the annuity starting date.)

Second, even if we were to grant that our earnings assumption will be realized, we cannot be sure that the “save for” scenario will produce the required income at eighty-five, because immediate annuity rates are sensitive to both interest rates and longevity.

Is the certainty that $100,000 today will buy us $7,259 per month, (or whatever income could be purchased at the time you read this chapter) for life, if and only if we reach age eighty-five, worth locking away that money, perhaps never to get it back? That’s not an easy question to answer. Our quantification example provides a baseline for the comparable return we must earn on our investments over the next twenty-five years to achieve the future lump sum required, which obliges us to note that earning an average return as high as 7.32 percent will entail some investment risk itself. Moreover, when we employ that baseline, we must remember that the longevity annuity pays off if and only if (though guaranteed if that point is reached).

Part of the difficulty stems from the fact thatour computation makes the valuation of the longevity annuity an investmentproblem. In the “save for” scenario, we’ve calculated how much money our investor would need to have accumulated at age eighty-five to obtain the amount of income that could be guaranteed *today* by a longevity annuity if he does, in fact, live that long. But only one of the two alternatives can occur. The real riskagainst which the longevity annuity provides insuranceis that our investor will live longer than anticipated, and that his assets may not be enough to produce a sufficient

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income over an unexpectedly long life. Arguably, if he doesn’t live to that age, he won’t need the money, because that long-life, or superannuation, risk never materializes. To put it bluntly, dead people don’t require income and probably don’t mind an unfavorable investment result that only occurred because they’re no longer around to witness it.

What if we modify the problem, using a longevity annuity that guarantees a return of all premiums paid if the annuitant dies prior to the annuity starting date? As of December, 2013, one insurer’s longevity annuity guarantees that a sixty-year-old male, contributing $100,000 in a single payment, will receive $4,993 per month for life at age eighty-five (and that all premiums will be paid to the annuitant’s beneficiary if he dies before age eighty-five). At that company’s current rates, a “life only” (no refund) SPIA for $4,993 per month will cost an eighty-five-year-old male about $402,000. What rate of return is required for $100,000 to grow to $402,000 after twenty-five years? The answer is 5.72 percent. Why is this computed interest rate significantly lower than the 7.32 percent computed in the “no death benefit” scenario? The answer is that the *leverage* in a longevity annuity with a death benefit is less than that of a longevity annuity with no death benefit; the potential annuity accumulates fewer mortality credits when a portion of funds must be held aside by the insurer to fund the refund guarantee for those who pass away early.

From a practical standpoint, we ought to note that the premium cost of a longevity annuity that might be lost if the investor doesn’t live to the annuity starting age should never be more than a fractionof that investor’s total portfolio for at least two reasons.

First, because a higher cost is not necessary.The premium required to guarantee a given level of income, commencing at age eighty-five, with a longevity annuity is but a fraction of the money that would be required to accumulate sufficient capital to produce that same income at age eighty-five *with total certainty*. Scott states that “the spending benefit a retiree could achieve with a ten percent allocation to a longevity annuity typically exceeds the benefit from a fifty percent allocation to an immediate annuity.”[[8]](#endnote-8) Our earlier example showed similar results. This significant difference occurs because the insurance company can pool the money for all those who don’t live to age eighty-five with those who do receive payments past age eighty-five, allowing the insurer to transform the liquidity that the purchaser gives up into an increased guaranteed benefit amount. This is what actuaries call a morality credit, and it’s what makes the longevity annuity so efficient.

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Second, because retirement income might not be the investor’s only goal. He or she may also have estate planning and legacy goals for heirs. In this case, the authors recommend that the client may be able to maximize both retirement and legacy goals by obtaining a pure longevity annuity to minimize the expense of insuring against an unexpectedly long life, while locking in the maximum leverage inherent in such a contract. The money freed up by this strategy is thus available for other uses, such as legacies.

# What about Inflation?

One major carrier offers two versions of its longevity annuity—one with a death benefit and one without—but both provide only a levelannual benefit. That is, there is no inflation increase or Cost-Of-Living-Adjustment (COLA) feature. Another insurer’s product offers consumers a choice of an annual increase ranging from one percent to five percent of the annual benefit, but the increase begins only in the second year of payout.

In other words, there is no protection against unexpected inflation occurring from policy purchase until the first payout year, which may render the first payment already insufficient to provide for the desired purchasing power of the retiree. Moreover, an individual longevity annuity owner who receives annuity payments over many years will see the value of those payments eroded by the inflation occurring during that payout period if there aren’t at least scheduled increases that will begin once payments *do* begin.

In the third edition of this book, the authors wrote that “The lack of inflation protection in most of the longevity contracts currently offered is worrisome.” Fortunately, in the two years since we made that comment, the situation has changed somewhat for the better. More insurers are offering longevity annuities and more of these contracts are offering inflation protection. A few contracts offer cost-of-living adjustments tied to the CPI-U, while most COLA provisions require the buyer to choose the rate (typically, no more than six percent) at which annual annuity payments will increase. The authors strongly encourage advisors to be very cautious in recommending longevity annuities with no cost-of-living adjustments as such contracts will almost certainly fail to provide a sufficient level of real (after inflation) income to meet the client’s entire future needs. Unfortunately, though, the authors are aware of no longevity annuities that provide a full inflation guarantee that addresses both the period between the purchase of the annuity and the annuity starting date, and inflation adjustments *after* the annuity starting date.

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One method of dealing with this problem, where the longevity annuity being considered offers no inflation protection for the deferral period, might be to estimate the future (inflated) level of income required and to recommend that inflated amount. Obviously, this assumes at the least that payments under the contract will be inflation-adjusted once the payout period begins; otherwise, calculating the future inflated income need but allowing that it will degrade every year thereafter is at best only a partial solution.

Another option might be to purchase a series of longevity annuities, such that the investor is buying additional protection as the need for it becomes apparent. Newer “Deferred Income Annuities” often provide the buyer with the opportunity to “lock in” future annuity values with each recurring premium as well as some flexibility in changing the annuity starting date after purchase. One U.S. insurer offers a longevity rider to one of its variable annuity contracts in which the rider premium is paid by installments, as a percentage of the total premiums paid into the annuity contract.

None of these solutions is, in the authors' opinion, as satisfactory as choosing a longevity annuity that offers protection against inflation occurring during both the payout and deferral periods. The authors hope that we will see such contracts as the market for this product matures.

# The Importance of a Death Benefit Feature

In conversations with marketing executives at two major insurers currently offering longevity annuities, one of the authors has been told that the overwhelming majority of advisors considering these products prefer a version offering a death benefit. In conversations with dozens of financial planners and insurance agents, the authors have heard the same thing. Apparently, most advisors believe that a client will not pay money for a product guaranteeing a substantial income at, say age eighty-five, if it pays no benefit if the client dies beforehand.

Viewed one way, this makes sense. Why would one invest one’s money in something that might never pay off, essentially risking a potential total loss (a negative one-hundred percent return)? Yet this viewpoint is, in the authors’ opinion, fundamentally misdirected for a very simple reason: A longevity annuity is not, in any way whatsoever, an investment. It is wholly a risk transferinstrument, a pure insurance play.[[9]](#endnote-9) The retiree is not facing the risk of a negative one-hundred percent *investment* return, but instead is simply making a *premium payment* for an *insurance guarantee* against a risk.

What is the risk in question? It is the possibility that you live longer than expected, such that your portfolio proves to be insufficient to fund your retirement with the time horizon

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that is longer than originally planned (such that retirement assets are depleted). That’s the risk. If that possibility so concerns you that you’re willing to part with a substantial insurance premium now to preclude it, even if that will mean losing that money if you never reach old age, then transferringthat risk to an insurer by making that premium may make good sense to you—just as you find it sensible to buy medical expense insurance knowing that if you don’t get sick, that insurance will never pay off.

The authors believe that the reason that some advisors don’t like longevity annuities without a death benefit is that they’re applying investmentanalysis to a product that isn’t an investment, or even an insurance product with investment features. The longevity insurance purchase decision should be, functionally speaking, identical to the thought process involved in purchasing a property and casualty product, where a premium is paid purely to insure a risk with no other benefit but the risk protection—and it should be evaluated as such.

Regrettably, that is nothow it has been marketed, if the brochures from the few insurers offering it are any indication. Most point-of-sale and agent training materials typically speak of the longevity annuity as an income investment product, which is half right and half dead wrong. A longevity annuity is all about guaranteeing income in the event of long life, but it’s nothing about investment, except to the extent that it’s a trade-off *against* using an investment approach instead. Until insurance marketers understand this, their producers (insurance agents and financial advisors) never will. Until we advisors do, our clients won’t either. Fortunately, a few insurers have realized this and their marketing material speaks more to risk transfer than to “investment.”

# Implications of the Longevity Annuity for Retirement Income Planning in General

The Longevity Annuity (or “Deferred Income Annuity”) concept has the potential to redefine the landscape of retirement income planning. Traditionally, the problem facing planners is to construct and manage a portfolio that will provide, at least to a minimum level of confidence, required levels of income throughout retirement. We make projectionsto model how various asset allocations and income distribution patterns will perform to that end. In doing so, we take into account numerous variables. That, by itself, isn’t hard, given the formidable computer software tools now available. The difficulty lies, of course, in the uncertainties. Even when we prescribe the levels of net real income required and assume particular tax and inflation rates, we’re left to deal with two fundamental uncertainties: (1) the level and sequence of investment returns; and (2) the length of the period over which income will be required.

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Various methodologies have been developed to help us do this. Stochastic techniques, such as Monte Carlo simulation, historical back testing (which uses actual returns over a specified earlier period), and “historical bootstrapping” (using actual historical returns, chosen randomly for each analysis year) are all in common use. Each method has its proponents and critics, but each must acknowledge that we do not know for certain: (1) what investment returns our client will earn each year; or (2) for how many years returns will be needed. The influence of each of these uncertainties upon our overall confidence is considerable, but the product of both—of these uncertainties compounded, if you will—exerts a profound impact upon the confidencewe feel about our results.

How much more confident could we be if one of these two uncertainties were removed—if, while we must guess at investment returns, we could know, for certain, the number of years over which those returns will be required to generate income? To the extent that a longevity annuity will provide, with certainty, the level of income our client needs on reaching a particular age—age eighty-five, for example—it transforms our “longevity continent” problem to one of a “period certain.” By incorporating this instrument in the client’s overall plan, we can know that his or her remaining assets will be required to last only until age eighty-five—because the longevity annuity will take it from there. (Though as noted earlier, the solution may be imperfect in today’s marketplace, due to the lack of contracts that provide a full inflation guarantee during both the deferral and payout periods.)

What kind of asset allocation decisions can now be made with regard to those remaining assets in the light of this new certainty regarding the retirement investment time horizon? Even more importantly, what kind of lifestylechoices may the client now make, with confidence?

Longevity annuities are still relatively new to the marketplace. Most insurers do not offer even one. But more and more are seeing the light. Newer contracts (which are usually called “Deferred Income Annuities”) frequently offer contract owners far greater flexibility in choosing the annuity starting date (often from age eighty-five to as soon as two years after purchase), the right to change the annuity starting date (usually, only once), and the opportunity to make additional contributions (which will purchase additional guaranteed income). As a result of this increased flexibility, and because “Deferred Income Annuities” have gotten much greater attention from financial journalists, more and more advisors are coming to realize the benefits that these contracts offer to their clients.

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In February, 2012, the U.S. Treasury Department and the Internal Revenue Service proposed a series of Treasury Regulations designed to make it easier for participants in employer-sponsored retirement plans and IRAs to invest in longevity annuities. Under the “Qualified Longevity Annuity Contract” (QLAC) rules, retirees will no longer have to deal with the Required Minimum Distribution aggregation of accounts rules and, under certain circumstances, will be able to postpone the application of those rules until the longevity annuities begin payout. These proposals represent a good start, but widespread acceptance of these tools has a long way to go.

Which is Best—a DIA or SPIA, or maybe a GLWB?

The authors are often asked this question by attendees of our presentations on retirement income planning. It’s an understandable question; financial advisors are always looking for the best solutions for their clients’ needs. But the only answer to this question can be “it depends”, because the “best” solution will always be a matter of individual facts and circumstances. Moreover, the question of “Which tool is best?” seeks a single solution when the optimal solution may be a combination of tools. In many planning scenarios, the solutions may include deferred income annuities working alongside and *in combination with* SPIAs or lifetime withdrawal riders (GLWBs).

One planning tool that incorporates such combinations is Curtis Cloke’s “THRIVE® Income Distribution System” (available at www.thriveincome.com). It uses the familiar “buckets of money” approach, by dividing the client’s required income streams into “buckets” and funding each bucket with either a SPIA, a DIA, or a GLWB (see Figure 8.1 below). This same process can be done in other financial planning software by subtracting from the client’s chosen asset account or accounts the cost of the proposed annuities and entering the income from those annuities as income streams. (In the case of a GLWB, you must be careful not to count both the accumulation value of the annuity contract containing the GLWB and the guaranteed income payments from that rider).

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Figure 1



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The Contingent Annuity

Recently, a number of Private Letter Rulings[[10]](#endnote-10) have addressed an entirely new type of annuity: the contingent annuity (also known as a contingent deferred annuity, or CDA). Essentially a stand-alone guaranteed lifetime withdrawal benefitrider without the underlying deposit to an annuity itself, the contingent annuity is a contract between an issuing insurance company and a customer, or the annuitant holding an investment account at a sponsoring organization and the sponsor. Once purchased, the customer will have a benefit base, similar to a GLWB in an annuity, that may be either the greater of the account balance, the balance on specified prior dates as a high-water mark, or the balance at inception accumulated at a specified rate of interest. As the customer takes withdrawals from his/her own account balance, so too are the withdrawals applied against the benefit base. And as with the GLWB, if withdrawals under this benefit result in the account balance falling below zero, the insurance element of the contingent annuity would come into play, and the insurance company will continue payments of the same amount to the annuitant for life; or, if a joint benefit is elected, the joint lifetime of the annuitant and his/her spouse. Again, though, the funds themselves remain invested in the customer’s own account balance, and not an annuity contract; the contingent

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annuity essentially forms a benefit base “wrapper” around the account, and costs for the guarantee—but only the guarantee—are paid from the account directly.

Unlike payments under the GLWB, payments by the insurer under a contingent annuity (in the event that payments kick in after the account balance has been depleted) will, based on the letter rulings cited, enjoy regular annuity rules taxation, where a portion of each payment is considered a tax-free return of principal under the exclusion ratio rules. Moreover, the investment account would not be considered an annuity contract, and returns in the investment account being protected by the contingent annuity would still be eligible for capital gains taxation.

There remains considerable confusion as to whether a contingent annuity is, in fact, an annuity contract. Contingent annuity contracts have been filed with insurance regulators in many states; in some states, they have been approved as annuity contracts. In others, they have not.

Status

The NAIC Life Insurance and Annuities (A) Committee charged the Contingent Deferred Annuity (A) Working Group with evaluating the adequacy of existing laws and regulations as applied to CDAs and whether additional solvency and consumer protection standards were required. At the 2013 NAIC Spring National Meeting, the CDA Working Group adopted a memorandum and recommendations for adoption by the A Committee regarding the future regulation of CDAs.

The CDA Working Group concluded that: CDAs do not easily fit into the category of fixed or variable annuity and should have their own definition; continuing review of solvency and consumer protection standards is appropriate; and tools to assist states in the review CDA product filings and solvency oversight of CDAs should be established. The Working Group also identified issues to be addressed by other NAIC committees and working groups with specific subject-matter expertise.

1. Gladych, Paula Aven “Fixed-rate Deferred Annuity Sales Jump,” benefitspro.com, Nov. 21, 2013, http://www.benefitspro.com/2013/11/21/fixed-rate-deferred-annuity-sales-jump [↑](#endnote-ref-1)
2. “LIMRA: Deferred Income Annuity Sales Reach $1 Billion; Fixed Indexed Annuity Sales Hit Record High in 2012,” (LIMRA News Release, Feb. 21, 2012), available at: http://www.limra.com/Posts/PR/News\_Releases/LIMRA\_\_Deferred\_Income\_Annuity\_Sales\_Reach\_$1\_Billion;\_Fixed\_Indexed\_Annuity\_Sales\_Hit\_Record\_High\_in\_2012.aspx. [↑](#endnote-ref-2)
3. Milevsky, ibid. [↑](#endnote-ref-3)
4. Milevsky, ibid. [↑](#endnote-ref-4)
5. Updegrave, Walter “Sure Income for the Very (Very) Long Haul” money.cnn.com, January 21, 2008, available at: http://money.cnn.com/2008/01/21/pf/long\_haul.moneymag/ [↑](#endnote-ref-5)
6. Scott, Jason S. “The Longevity Annuity: An Annuity for Everyone?” (working paper, June 2007), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=992423 [↑](#endnote-ref-6)
7. Rates for both immediate and longevity annuities vary considerably by age and sex and by insurer. The results of this comparison might be very different for a client of a different age and/or sex, or if contracts from a different insurer were used. [↑](#endnote-ref-7)
8. 11Scott, ibid. [↑](#endnote-ref-8)
9. See Olsen, John L., “Longevity Annuities Could Redefine the Retirement Income Planning Landscape,” Life Insurance Selling (January, 2009), available at: http://www.lifehealthpro.com/2009/01/09/longevity-annuities-could-redefine-the-retirement. [↑](#endnote-ref-9)
10. See Priv. Ltr. Rul. 200949007 (July 30, 2009), Priv. Ltr. Rul. 201002016 (Oct. 6, 2009), and Priv. Ltr. Rul. 201129029 (March 17, 2011). [↑](#endnote-ref-10)