Deferred Income Annuities

By Brian Wilson

We've all heard the reports. Defined benefit plans are disappearing. Social Security is at risk. More and more, Americans are feeling underprepared for retirements that could last as long as 25 or 30 years. Discussing wealth protection is a top driver of client satisfaction, yet only 41 percent of clients actually have discussed wealth protection with their advisors.¹ As Americans face retirement, solutions that provide lifetime income guarantees have become more vital for helping clients achieve their retirement objectives.

So where can they turn? Fewer than 5 percent of retirement savers who are covered by a defined contribution plan have access to guaranteed lifetime income through those plans. For the remaining 95 percent, and for all the retirement savers without access to any employer-sponsored plan, the only way to get guaranteed lifetime distributions is through an annuity.² Annuities are insurance products designed to help protect a client from the risk that the client will outlive his or her savings. As part of an overall retirement strategy, an annuity may be designed to provide income payments (distributions) for as long as the client lives in exchange for a premium. Different kinds of annuities have different features and payment options to meet specific needs and priorities.

Deferred income annuities in particular have garnered increased attention over the past several years, growing from approximately $230 million in sales in 2011 to $2.7 billion in 2015.³ More advisors are looking to this solution as a way to manage longevity risk for their clients. One main reason is simplicity: Clients choose when they want annuity income to start, the payment option, and the frequency that works best for them. The main attraction, however, is the guarantee. Clients who purchase deferred income annuities today know exactly what their incomes will be in 10, 20, or even 40 years, and they may have the option to have payments adjusted to account for inflation. Because there is no access to an account value, clients are able to maximize the overall level of guaranteed lifetime income they will receive by foregoing liquidity. Other benefits may include the ability to add additional sums of money, adjust the start date (which may result in a change in payment), and accelerate several months’ worth of payments at one time. These options add flexibility to customize plans as needed.

Deferred income annuities provide various payout options that can provide income for a certain period of time or for life. Some options feature a return-of-premium death benefit during the deferral phase, which means that if the client dies before income payments begin, the original premium or premiums would be paid to the beneficiaries. Death benefits during the income phase can be based on either a return of premium (less the amount of any payments made) or the amount of any remaining guaranteed payments.

Deferred income annuities can be utilized in a number of ways to address many key concerns today’s clients may face before and during retirement such as:

- What if I run out of money?
- What if I need to retire early?
- What if my healthcare costs increase or I need long-term care?
- How can I minimize the impact of RMDs?

Let’s take a look at each of these challenges and see how a deferred income annuity might be able to help.

What If I Run Out of Money?

About one in every four people who are 65-years-old today will live past age 90, and one in 10 will live past age 95.⁴ Clients need to be prepared for a retirement that could last 20 to 25 years and maybe longer. The conventional wisdom of drawing down 4 percent annually from retirement assets could result in a client exhausting retirement savings at a time when it may be needed most. Utilizing a deferred income annuity with a lifetime payout option will...
give a client a guaranteed income stream that will last a lifetime.

**What If I Need to Retire Early?**

People may need to retire early for several reasons. They may have lost their jobs, they may no longer be able to perform required job duties, or they may just want to start enjoying their retirement years. Leveraging the period certain option on a deferred income annuity can provide supplemental income until other sources of retirement income such as Social Security are available. Consider the following hypothetical example to see how this would work.⁵

Manny is age 50 and plans to retire early at age 60. He's determined that he needs $3,500 of monthly income in retirement. At age 70, Manny's Social Security benefit, combined with other retirement income, will provide him with $3,500/month. To retire at age 60 and get the income he needs, he uses $250,000 to purchase a deferred income annuity with a 120-month period certain that gives him $3,571/month for 10 years. This allows Manny to retire 10 years early and delay taking income from other investments or Social Security, giving him the opportunity to maximize those benefits.

**What If My Healthcare Costs Increase or I Need Long-Term Care?**

Fifty-two percent of people who are alive at age 65 can anticipate some need for long-term care services, but fewer than one in four express confidence that they will have the financial resources necessary to pay for them.⁶ According to advisors, long-term care expenses can deplete client resources two to three times faster than intended.⁷ Consequently, consumers are rightly concerned that their healthcare expenses may increase over time and that their current sources of retirement income will not be able to meet the need.

A deferred income annuity can provide an extra stream of income later in life to help cover these expenditures. For example, a 65-year-old female who purchases a deferred income annuity with $100,000 and selects the life with cash refund option could schedule income to start when she turns 85 and receive $2,700 a month in extra income guaranteed for the rest of her life.⁸ In this scenario, if the annuity holder dies before age 85, the full premium would be distributed to the beneficiaries.

**How Can I Minimize the Impact of RMDs?**

Clients with individual retirement account (IRA) assets who are approaching age 70½ face taking required minimum distributions (RMDs) from their accounts whether they need the income or not. Taxes are due on the amount of the distribution, which may be frustrating for consumers who don't need the additional income. In 2014, the U.S. Department of the Treasury announced new regulations that permit clients to purchase a deferred income annuity with IRA assets and receive qualifying longevity annuity contract (QLAC) status, enabling them to defer taking RMDs on that amount until age 85. QLACs can be purchased with the lesser of $125,000 or 25 percent of a client's aggregate traditional IRA account balances. For a 70-year-old with $500,000 in traditional IRA assets who does not need income now, investing $125,000 in a QLAC may result in the following benefits:

- Deferral of a portion of RMDs until age 85
- Current RMDs based on account value of $375,000, which reduces RMD income by about $70,000 ($279,000 to $209,000 over 15 years) and taxes by $23,000 (based on a 33-percent tax rate)
- Protection for heirs if death occurs before age 85 by using the life with cash refund option
- Guaranteed income from age 85 until death⁹

**Conclusion**

Deferred income annuities may be used in a number of different ways to provide security, guarantees, and peace of mind to a client's retirement strategy. As with all investment choices, advisors should counsel clients on the pros and cons of each choice. Clients' top five concerns when planning for retirement are taxes, long-term expenses, longevity, market risk, and inflation,¹⁰ and deferred income annuities can be used to address each one. Solutions that provide guaranteed lifetime income are essential for a successful retirement plan, and deferred income annuities are a simple way for retirees to achieve that end. ⚫

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**Endnotes**

2. LIMRA Secure Retirement Institute, “In-plan Guarantee Availability and Election Tracking Survey-2014” (guaranteed income products available in 33,500 qualified plans representing less than 5 percent of all plans and less than 1 percent of defined contribution assets), www.limra.com.
5. Hypothetical rates are displayed. Actual rates are determined at the time of purchase and are based on age, gender, effective date of the contract, date payments start, and payment frequency.
6. Social Security Administration, cited above.
8. This example is based on the average payment of carriers quoted on Cannex, based on rates effective June 1, 2016.
9. Payment amount is taxable as ordinary income.
10. Lincoln Financial Group and Hanover Research, see endnote 1.

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