Immediate Annuities and Gift Planning - Part One

Boring Product, Creative Applications

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Summary

In Part One of a two part series, annuity expert Bryan Clontz gives a brief education on commercial annuities and charitable gift annuities and provides a comparison of the income tax, cash flow and charitable portions of the annuity transaction.

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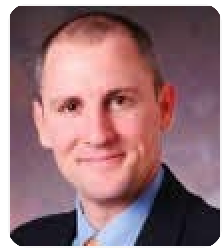

Fixed immediate annuities are as simple as it gets – an insurance company receives a premium in exchange for a guaranteed lifetime income. This simple product has a number of innovative gift planning applications for charities and donors alike. Most importantly, immediate annuities can provide solutions for gift planning challenges where other products or vehicles may not.

This presentation will first discuss and define annuities from a broader context, the historical and current market for immediate annuities, followed by the math and investment assumptions and, finally, how commercial annuities compare with charitable gift annuities.

I. Definition of Annuity Types and Options

There is an array of commercial annuities available. The following is a brief description of the more common products and payout options. This paper is focused only on fixed immediate annuities, but it may be helpful to understand other choices available in the marketplace. In 2012, combined annuity premiums were $212 billion.[i]

Fixed annuity: A fixed annuity pays a guaranteed interest-crediting rate, like a CD, for a specific period of time. This interest and principal is guaranteed subject to the claims-paying ability of the life insurance company.

Variable annuity: A variable annuity is not guaranteed with the principal and income fluctuating based on the selected investment portfolio; these are separate investment accounts, which function similar to mutual funds.

Indexed annuity: Rather than a fixed annuity paying an interest rate set by the insurance company, an indexed or equity-indexed annuity pays a crediting rate based on a publicly available index, e.g., S&P 500. The annuity often has a percentage rate of participation in the index as well as a capped maximum rate. These annuities generally have minimum guaranteed interest rate floors to protect downside losses.

Deferred annuity: A deferred annuity can either be fixed, indexed or variable and the principal and interest will accumulate for some period of time before annuitization – that is, making periodic payments over the life-time or fixed period. Purchasers may choose one lump sum premium or may contribute flexible premiums over time.

Immediate annuity: An immediate annuity can either be fixed, indexed or variable and where the principal and interest have been annuitized. Generally, buyers purchase with one lump sum – a so-called *Single Premium*

Immediate Annuity (SPIA).

Annuity options: Once an annuity has been annuitized, the owner has a number of payout options and riders.

- One is called a life-only payout, which makes payments for one life or two lives.
- Next is a period or term-certain payout. This can be added to the life-only payout – say, the greater of life-only or 10 year period-certain – or it can be a stand-alone period-certain annuity.
- For joint-life annuities, the owner can select a joint and survivor 100 percent, 66 percent, 50 percent and so on. For example, an annual annuity payment of $1,000 would be reduced for the survivor to $500 under a joint and survivor 50% payout selection.
- Finally, a person might select a cash refund option whereby the insurance company would pay a death benefit equal to the original premium minus all payments made prior to death.

These brief annuity descriptions are not exhaustive, but they do provide some of the more common types of contracts and payout options available on the commercial market.

Outside of the commercial market, other well-known annuities are Social Security, military pension and an employer pension under a defined benefit plan. These options are synonymous with an inflation-adjusted, life-only, immediate fixed annuity with a joint and survivor benefit option. These retirement income options are the same as immediate annuities which is covered next in greater depth.

II. Immediate Annuities: History to Present

Immediate annuities have a long and colorful past and even include a number of charitable applications. The first recorded evidence of annuities was found in Babylon 2500 B.C. They were used in the Roman Empire for retiring military pensions. President Lincoln used annuities in a similar way to reward Civil War military leaders in lieu of land grants. One of the first known annuity sellers was Gnaeus Domitius Annius Ulpianis in Rome 210-220 A.D. He is also credited with developing the very first mortality table used for annuity pricing.

In the Middle Ages, particularly from 700-1300 A.D., citizens would give a lump sum to churches and hospitals in return for a lifetime income. The Catholic Church began offering annuities in the 700s and other churches quickly offered similar arrangements. Most payouts were the same for every age and there is evidence that they were highly profitable.

Interestingly, there was a widespread prohibition against usury and, in some cases, paying any interest on loans. Medieval courts allowed annuities, however, because "the gain was uncertain and therefore did not constitute usury." This may be, in essence, the first evidence of a charitable gift annuity, as the residuums were used to fund church and hospital budgets. Here is an excerpt which many charities today may relate to:

> *"In 1308 a French Archbishop paid the Abbey of Paris 2,400 livres in exchange for a life annuity of 400 livres a year. The Abbey accepted, apparently believing the Archbishop was in poor health. Fifteen years later, with the Archbishop still alive, the Abbey sued to have the contract stopped claiming so much had been paid out that the annuity was "usurious." The court refused to hear the case and the Archbishop collected a total of 7,600 livres before he died in 1327 earning an effective annual return of 15.6%."*[ii]

There is strong circumstantial evidence that these very annuities may have funded a portion of the Renaissance. European churches, in particular Catholic, were one of the largest issuers of these annuities in the 14th century – the same time of the bubonic plague (aka, Black Death). When the plague killed between 30-60 percent of the continent's population from 1320-1380, churches benefited from shorter than expected annuity payouts and therefore received very large residuums.

Like a puzzle piece almost perfectly fitting together, some scholars date the Renaissance's birth at 1401. While there is no direct evidence that annuities, or "corrodies" as they were called, funded the Renaissance to the extent of indulgences, the math and timing would make it hard to argue that these Medieval gift annuities did not play some funding role.

Governments, seeing an excellent revenue opportunity, quickly joined the immediate annuity distribution market. In 1100, Venice was the first government to issue annuities, followed by most other countries in the 1500s. In 1690, England issued annuities the equivalent of half a billion dollars to fund government expenses and wars.

The first North American charitable use of annuities was by the Presbyterian Church in 1720. The initial purpose was to provide for aging/retired ministers and their families. It quickly expanded to cover widows and orphans.

Another charitable use of annuities occurred when Benjamin Franklin left two annuities to Philadelphia and Boston in his will to benefit the citizens.[iii] Boston surrendered the last of the Franklin annuities in 1993.

Since the Great Depression, only life insurance companies can sell commercial annuities to the public and the 58 largest providers today represent 95 percent of all sales. Most annuities are sold through traditional and independent life insurance agents, though bank sales of annuities have ranged between 15-25 percent. Note that local, state and federal government, and employers may provide pension annuities, and that charities may provide charitable gift annuities. Because of contractual guarantees, annuities tend to be most popular during volatile financial markets with less risk-tolerant investors and with individuals estimating a long life expectancy.

III. Immediate Annuity Math and Investments

The math behind fixed immediate annuity investments is based on three variables: mortality, investments and expenses. A summary of each of these components follows:

Mortality: The insurance company statistically manages any mortality deviations through the law of large numbers. Most also use company-specific internal experience mortality tables though using the Annuity 2000 Table, with appropriate future mortality improvements, is a reasonable proxy. Some people who buy annuities die sooner than expected and some, of course, die later. The insurance companies are able to provide these "mortality credits" to survivors. This is how immediate annuities generate a higher level of sustainable income than any other investment earning the same return. This benefit is so strong, that until 2011 in the United Kingdom, all pensioners were required to purchase an annuity called a *Compulsory Purchase Annuity* at age 75. The research showed that after 75, it became extremely difficult if not impossible to out-return the immediate annuity and their inherent mortality credits.

Investments: The interest-crediting rate is based on the current fixed income yields relative to the annuitant's life expectancy. A very simple example would be a 70-year-old female with a 20 year life expectancy. If a market basket of fixed income investments produces a guaranteed yield of five percent, the product might have an internal rate of return to life expectancy of four percent. The insurance company profits from the yield spread between the amount earned and the amount credited.

Expenses: Immediate annuities are the least transparent in terms of expenses. Most of the expenses and profits are used to reduce the crediting rate, more simply said, expenses are buried in the interest spread. The insurance company pays all administration and sales commissions (which are nearly always four percent up-front with no trailing fees) and then receives any remaining profits.

Figure 1 provides a visual example of how a constant payment's make up changes dramatically over time.

Figure 1 - Immediate Annuity Annual Payout Breakdown Over Time

IV. Retirement Income Applications

Over the last decade, research has shown that the unique attributes of immediate annuities are perfectly designed to provide investment and longevity hedging for retirement income. In a recent article by Professor Wade Pfau, he states "The optimal investment efficient frontier generally consists of combinations of stocks and fixed SPIAs. Perhaps surprisingly, bonds, inflation-adjusted SPIAs, and VA/GLWBs are not part of the efficient frontier in the couple's optimal retirement income portfolio."[iv]

In addition to the mathematically optimal use of immediate annuities in the retirement income space, there are two major behavioral factors in play.

- First, a concept called disappointment aversion in which negative feelings associated with a loss are significantly greater than the positive feelings derived from a gain of the same size. This is what causes many retirement investors to seek guarantees over growth.[v]
- Second, there are two relatively new approaches to retirement income planning called the flooring approach and the bucket strategy. Under the flooring approach, a retirement income portfolio is designed to cover all essential spending through guaranteed income streams like Social Security, pensions, commercial annuities or charitable gift annuities. All other assets can then be deployed to maximize inflation-protection, growth and other legacy goals since that use is targeted more for discretionary spending. The bucket strategy deploys assets based upon when withdrawals are needed. For example, there might be a short-term bucket that is likely to be spent within 1-3 years with cash, cash equivalents and other guaranteed assets. Then another asset bucket for 4-10 years, and then perhaps one for 11+ years.

Many of these strategies use immediate annuities for the guaranteed income, increased mortality credits over time, and as a longevity hedge. Because of this high demand, insurance carriers are now manufacturing products called delayed income immediate annuities, or longevity annuities. These allow a person to provide a single premium today, say at 60, but with guaranteed income that doesn't begin until 80 or 85. In the purest form, there is no refund for death prior to the start date, but the rate compounds the longer the deferral and can off-set any longevity concerns. This specialized annuity product allows people to buy their own pensions and now represents a $2 billion annual market.

There are many corollaries between retirement income research findings and charitable giving. Most of the largest charitable donors are 65 years old or older and are struggling with important life event decisions like Social Security, retirement income and charitable giving. In many cases, annuities are used in the retirement income arena to allow a donor to make a large donation. Charities are also managing similar retirement income vehicles with charitable gift annuities as well as charitable remainder unitrusts and annuity trusts.

V. Immediate Annuities vs. Charitable Gift Annuities

Immediate annuities are very similar to charitable gift annuities, while having many clear differences. The simplest way to describe a charitable gift annuity is as a horribly priced commercial annuity. The charitable overpayment for the same level of benefit is the charitable gift. Some other comparisons and contracts follow.

Volume Differences: Immediate annuities, in every form, are estimated to be a $40 billion annual market. Charitable gift annuities have estimates closer to the $200-400 million range.

Provider Differences: There are roughly 75 life insurance companies offering immediate annuities. There are estimated approximately 2,000 charities offering gift annuities.

Primary Market Differences: Immediate annuities are typically purchased by people between 62-64 years old. Charitable gift annuities are entered into by people between 77-78 years old.

Payout Differences: An immediate annuity might provide a payout rate of seven percent for a 69-year-old male (note this includes gender-based pricing) where the same donor might have a five percent gift annuity.

Taxation Differences: If funded with cash, the exclusion ratio applies to both products similarly in that a portion is a tax-free return of cost basis, and a portion would be ordinary income (different ratios may apply because of the different assumptions). But only a charitable gift annuity can be funded with appreciated property and benefit from the tax advantaged installment sale recognition over life expectancy.

Legal Differences: A commercial annuity is a registered product and subject to all insurance regulations including reserve requirements, licensing and state guarantee funds. A charitable gift annuity is a contract with a charity that is part annuity and part donation. If a charity meets all the requirements of the *Philanthropy Protection Act of 1995*, it is not required to register the annuity as a security. The charity is also not required to be a licensed insurance company and its fundraisers are not required to be insurance or securities licensed. The charity should comply with any charitable gift annuity state regulations where it is domiciled as well as the donor's legal residence.

VI. Summary

An immediate annuity is a straightforward product with a colorful history and very high current demand. But while its use is significantly increasing in the retirement planning and income sphere, it has been slower to catch on with gift planners.

VIII. Endnotes

[i] For a full set of annuity statistics see - http://www.iii.org/fact-statistic/annuities and www.limra.com/uploadedFiles/limracom/Posts/PR/Data_Bank/_PDF/Annuity-Est...

[ii] See www.advantagecompendium.com/1-10%20Annuity%20History.pdf

[iii] Very interesting transcript of Benjamin Franklin's will - learn.fi.edu/franklin/family/lastwill.html

[iv] See Dr. Pfau's article here www.fpanet.org/journal/ABroaderFrameworkforDetermininganEfficientFrontier/ also additional articles on the same topic are:

> Milevsky, Moshe A., and Huaxiong Huang. 2011. "Spending Retirement on Planet Vulcan: The Impact of Longevity Risk Aversion on Optimal Withdrawal Rates." *Financial Analysts Journal* 67, 2 (March/April): 45–58.
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> Ameriks, John, Robert Veres, and Mark J. Warshawsky. 2001. "Making Retirement Income Last a Lifetime." *Journal of Financial Planning* 14, 12 (December) 60–76.

[v] See Gul, F. 1991. "A Theory of Disappointment Aversion." *Econometrica*, vol. 59, no. 3 (May): 667-686.

Next week we will feature Part Two - Ten Commercial Immediate Annuity Applications in Gift Planning: A Case Study Approach

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