Financing Your Retirement Future

Spring, 2009

Coping with a Slower Economy

Economics isn't called the "dismal science" for nothing. There's an old joke that accuses economists of having predicted 9 of the last 5 recessions (and yes, those figures are in the correct order). However, forecasting the direction of the economy can seem easy compared with trying to figure out how to weatherproof your finances. It can help to understand some of the questions that many investors ask themselves if they're concerned about the potential impact of slower growth.

Is it time to check my portfolio?
Changing consumption patterns can have implications for a variety of companies and industries, and create investing opportunities. Some investing sectors might be especially economically sensitive and might therefore suffer from any economic downturn. On the other hand, some industries or companies may actually benefit from a slower economy. For example, companies that produce high-end goods might be relatively immune from economic pressures--or maybe not. Shifts in spending patterns could also mean that consumers continue to spend money but choose less expensive alternatives, or focus more on getting the greatest value from each dollar.

If you rely on your investments for income, you may want to review how sensitive your portfolio might be to changes in interest rates. If the Federal Reserve Board sees greater danger from a slowing economy than from the possibility of higher inflation, lower interest rates could cut into your income. Conversely, if the Fed becomes increasingly concerned about inflation, rates could go up. It might be a good time to see whether the yields you're receiving are competitive, and what kind of impact on your monthly income you might expect from any changes in rates.

Should I review my asset allocation?
Now might also be a good time to reexamine how your assets are divided among various types of investments. If you decide you need to shift a portion of your portfolio, those changes don't necessarily have to be made all at once. Consider:

- Adjusting only a portion of your bond or stock holdings
- Using systematic investing to shift allocations overtime
- Investing any new money differently to increase your exposure to asset classes you may have neglected

How close am I to the edge financially?
The benefits of reducing debt should be pretty obvious, given the recent credit crisis. Troubles in the mortgage industry have driven home the importance of managing debt wisely. The last thing you need if you're worried about uncertain economic times is to lock yourself into spending patterns that push you beyond your means. Whether the economy is in robust health or seems to be catching the flu, it's never a bad idea to have a cushion against unexpected financial stress. An unanticipated medical emergency--and is there any other kind?--a sudden job loss, or anything else that affects your income stream can bring the effects of a slower economy home in a dramatic way.

If you're employed in a highly cyclical industry or one that's undergoing substantial changes, having a financial reserve becomes even more important. And if a lot of your retirement plan savings are invested in your employer's stock, think about whether your long-term finances might potentially face a double whammy. Serious financial trouble at your company could mean the possibility of layoffs, a drop in the value of your holdings--or both.

Have I planned for the unexpected?
If you're planning to retire in the next few years, consider the potential impact if you were to be "retired" prematurely. It's easy to assume you'll work until a certain date or earn income after retirement, but health concerns and the job market don't always permit that. Doing some "what if?" calculations with an earlier retirement date than you might otherwise choose could prepare you for what might happen if you were laid off and had difficulty finding new employment, or were unable to work for health reasons.

A transition to a post-retirement career is likely to be easier if you plan thoroughly. For example, launching a small business can be challenging under the best of circumstances; try to have as much of the groundwork laid as possible before relying on it for your entire income. Sales estimates that are more conservative than they might otherwise be may help minimize cash flow problems.

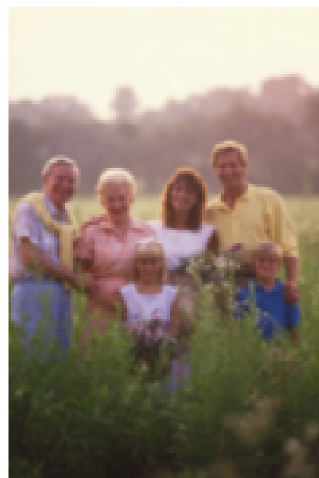
Asking questions such as these lets you hope for the best while preparing for the worst.

Annuity Maximization: A Strategy to Leave More to Your Heirs

What if you're living comfortably in retirement and find that you don't need a deferred annuity you bought years ago? Instead, you want to leave it to your heirs at your death. What you may not know is that transferring your deferred annuity at death may subject it to both estate and income taxes. A strategy that can minimize the impact of these taxes is called annuity maximization using permanent life insurance.

Some background

When you die, the portion of the annuity death benefit received by your beneficiaries (either in a lump sum or as periodic payments) that exceeds your investment in the annuity is includible as taxable income to your beneficiaries.



In addition, the full accumulation value of your deferred annuity is includible in your gross estate at your death. If your estate is large enough to owe federal and/or state estate taxes, your deferred annuity will be subject to those taxes as well.

The combination of estate and income taxes can erode a significant portion of your annuity's value. The result is that your beneficiaries may receive an annuity worth much less than you anticipate.

How annuity maximization works

Here's the basic way this strategy works: you exchange your deferred annuity for a single premium immediate annuity (SPIA) that provides an income stream to you for the rest of your life. You then obtain permanent life insurance with you as the insured, and use the SPIA distributions to pay the insurance premiums. At your death, the SPIA payments stop and the insurance proceeds are paid to your beneficiaries.

Alternatively, if you prefer to retain the deferred annuity instead of converting it to an SPIA, you may be able to take penalty-free withdrawals from your deferred annuity, which also can be used to pay the insurance premiums. However, annuities vary as to penalty-free withdrawal availability, so for complete details, be sure to check with the annuity issuer, or review your annuity contract or prospectus.

Caution: *Annuity distributions before age 59½ may be subject to a 10% federal tax penalty. Annuity guarantees are based on the claims-paying ability of the annuity issuer.*

The annuity maximization strategy may pose some income tax issues for you. SPIA payments and annuity withdrawals may be taxable to you. A portion of each SPIA payment you receive is subject to income taxes and a portion is considered a nontaxable return of premium. Conversely, withdrawals from your deferred annuity (for annuities issued after 1982) are taxed as income first, meaning the entire withdrawal is includible as income until all of the annuity's earnings are withdrawn, after which withdrawals of principal are not includible as income.

Why annuity maximization works

Instead of getting the deferred annuity at your death, your beneficiaries receive the life insurance proceeds, income tax free. And you can effectively remove the value of the deferred annuity from your estate by converting it to a SPIA. Since the SPIA payments cease at your death, the SPIA is not included as an asset of your estate.

In addition, the life insurance can escape estate taxes if the policy is not part of your estate at death. To achieve this goal, you can't own the policy; it must be owned by another (e.g., your child or an irrevocable life insurance trust). You then make gifts to the policy owner equal to the annual insurance premium. However, gifts may be subject to both federal and state gift taxes, so you should consult your tax professional before making such gifts.

The bottom line

If you own an annuity that you want to transfer to your heirs at your death, a significant portion of its value may be lost to estate and income taxes. Annuity maximization is a strategy that lets you replace part or all of a taxable asset (your deferred annuity) with an asset (permanent life insurance) that may be subject to neither income nor estate taxes at your death. This approach may effectively allow you to increase the amount you pass on to your beneficiaries.

Guaranteed Lifetime Withdrawal Benefit

Tax-deferred annuities can be a valuable tool, particularly for retirement savings. Fixed and variable annuities earn interest on premium(s) paid to the annuity issuer, and interest earnings accrue tax deferred prior to being withdrawn. Variable annuities offer purchasers a choice of investment subaccounts into which the premium may be allocated, whereas fixed annuities pay interest based on a fixed rate determined by the issuer. Both types of deferred annuities offer a minimum death benefit. Deferred annuities also provide withdrawal options including payments that last for the life of the purchaser (annuitization). Due to growing demand for additional income options, some issuers are offering a rider, called a guaranteed lifetime withdrawal benefit (GLWB), which allows you to get lifetime income while continuing to have access to the annuity's remaining cash value.

The basic features

While its features may differ depending on the issuer offering it, the basic GLWB rider provides lifetime withdrawals without annuitization, which are subtracted from the annuity's cash value. These minimum guaranteed withdrawals are based on a percentage (the "withdrawal percentage") of the greater of your premiums paid or the accumulated cash value.

Some added features

Some GLWB riders increase the withdrawal percentage based on the age at which you begin taking withdrawals. For example, the withdrawal percentage could be 5% at age 55, 7% at age 70, and 8% at age 80. Before you begin taking withdrawals, some issuers apply a minimum rate of interest to your premium(s), such as 5% per year (the minimum income value). Thereafter, the amount of each minimum guaranteed withdrawal is based on a percentage of the greater of the minimum income value or the annuity's cash value.

Your minimum guaranteed withdrawals may increase over time. The value used to determine the minimum guaranteed withdrawal is recalculated, such as every five years, allowing you to benefit if your account value goes up. Say you elect to receive minimum guaranteed withdrawals of $7,500 per year, based on a withdrawal percentage of 5% applied to the annuity's cash value of $150,000. Five years later, the annuity's cash value increases to $160,000. The new minimum guaranteed withdrawal is $8,000 per year The new minimum guaranteed withdrawal will not decrease, even if the annuity's cash value later decreases or is exhausted. As a result, future unfavorable investment returns negatively affecting your cash value will not negatively affect your income.

Access to cash values

Most issuers allow you to take money from your cash value, even if you are receiving GLWB withdrawals. However, some issuers reduce future minimum guaranteed withdrawals in proportion to the amount you take from the cash value. For example, let's say you have a cash value of $100,000 and your minimum guaranteed withdrawal is $5,000 per year. You withdraw an additional 10% ($10,000) from the cash value. Correspondingly, your subsequent GLWB withdrawals are reduced by 10% to $4,500.

Costs

Most issuers charge an annual fee for the GLWB rider, usually ranging from .1% to 1.0% or more of the annuity's cash value. Review the prospectus, sales materials, and the contract for information on charges and fees.

Death benefit options

Unless altered by a death benefit provision or rider, annuities with the GLWB rider usually pay a death benefit equal to the greater of the remaining cash value or the remaining premium, if any, less withdrawals and applicable surrender charges. Generally, GLWB withdrawals are available only to the annuity owner and not his/her beneficiaries, unless the beneficiary is the owner's surviving spouse, in which case the withdrawals may be continued for the benefit of the spouse.

Is it right for you?

You may want to consider a deferred annuity if you have contributed the maximum amount to your other retirement plans and you'd like another long-term investment. A deferred annuity with the GLWB rider may be a good option if you want a guaranteed income but don't like the idea of giving up access to your money that annuitization requires. When considering any annuity, keep in mind that annuity guarantees, including those associated with benefit riders, are based on the claims-paying ability of the issuer. Additionally, annuity withdrawals made prior to age 59½ may be subject to a 10% federal tax penalty.

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