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SINGLE PREMIUM IMMEDIATE ANNUITY

The Annuity Concept

- An annuity contract specifies that the insuring company will make regular payments for a specified time period, or for the life of the annuitant, in return for one or more premium payments from the contract owner.
- The annuitant is the person who receives the annuity payments.
- The contract owner (who may or may not also be the annuitant) is the person who purchases the annuity, pays the premium and is responsible for any tax due on distributions.

Immediate Versus Deferred Annuities

- As the name suggests, single premium immediate annuities (SPIAs) are purchased with a single premium and begin making payments immediately—usually within 30 days but no more than one year from the date of the first premium payment.
- Deferred annuities, on the other hand, may be purchased with either periodic payments or a single payment and begin making payments at some time in the future.
- The owner elects the payment frequency on the application—anywhere from monthly to annually.

Source of the Single Premium

- Single premium immediate annuities (SPIAs) or single premium deferred annuities (SPDAs) are often purchased by people who have received or accumulated a large sum of money.
- This money typically comes in the form of an inheritance, a life insurance death benefit, a maturing certificate of deposit (CD), or a lump-sum retirement plan distribution.

Fixed, Variable or Indexed Annuities

- Fixed annuities have earnings guaranteed by the insurer.
- Variable annuities have earnings allocated to a separate account that invests in securities. There are no guarantees.
- Indexed annuities have earnings that reflect the performance of an outside index, such as the S&P 500, without being invested directly in equities themselves. The insurer may or may not guarantee a minimum payment amount.

- When the annuity is fixed, the payments to the owner or payee are a fixed amount. When the annuity is variable or indexed, payments may be either fixed or variable.

The Procedure

- The insurance company deposits the single premium into either (1) a general account paying interest at a guaranteed rate (fixed annuity) or (2) one or more separate accounts paying interest at a rate that varies with the performance of the underlying securities. The indexed annuity contract describes the interest crediting procedure, which is tied to a stock index (this procedure differs from insurer to insurer).
- Insurers may guarantee a current interest rate for a specific period of time, after which the rate is adjusted based on the interest rate environment. Of course, guarantees depend on the claims-paying ability of the insurance company.
- A guaranteed minimum interest rate is typically specified (except for variable annuities) and will apply even if current interest rates fall below the minimum.
- With a variable annuity, no minimum is guaranteed and loss of principal is possible. The actual return depends on the market performance of the separate accounts in which the premium is invested.
- The premium paid and the interest earned provide a stream of income, designed (but not always guaranteed) to provide payments throughout the annuitant's lifetime, for a certain period of time, or some other combination.

Payout Options

Insurance companies offer a variety of payout options that determine how each payment is calculated. These include:

- **Straight-life or life-only annuity.** This option has the advantage of providing the maximum periodic payout, but payments end at the annuitant's death.
- **Joint-and-last-survivor annuity.** Payments are made until the death of the last annuitant. Sometimes a reduced payment (often two-thirds or one-half) is made after the first annuitant dies.
- **Period-certain annuity.** Income is paid for a specified period of time. The amount of each payment is determined by the length of the payment period, the interest rate, and the accumulation amount available when annuity payments begin.

- **Amount-certain annuity.** A specified amount is paid regularly over a period of time that depends on the accumulation amount, the interest rate, and the amount of each payment.
- **Refund annuity.** If the annuitant dies before recovering the full premium through annuity payments, the insurer will provide either continued income or a lump-sum settlement to a named beneficiary.
- **Death benefit.** The death benefit depends on the payout option elected.

The Tax Picture

- If the premium used to purchase an immediate annuity is from qualified funds, such as a pension plan or other retirement arrangement in which taxes have been deferred, the entire payout is taxable (since prior taxes have not been paid).
- If premiums are not based on qualified funds, payments to the annuitant are taxed under the IRC Section 72 annuity rules, which generally permit the tax-free recovery of basis spread over the taxpayer’s life expectancy (or joint expectancies for two or more annuitants).
- Under Section 72, only the earnings are taxed—not the principal. The amount to be excluded from taxation for each payment is called the exclusion ratio, which the insurer calculates based on prescribed life expectancy tables.

Special Considerations

Annuities are not for everyone. Buyers should be aware of certain features, including the following:

- To purchase an annuity, buyers should only use funds that will not be needed for other purposes because, in many cases, the buyer may not change the contract after payments begin. However, some immediate annuities pay the “commuted value” if the contract is terminated or surrendered—essentially, the present value of the remaining payments that would have been paid had the contract remained in force.
- Historically, immediate annuities have not provided liquidity beyond the regular stream of income to be paid in installments, with no provision for withdrawals. However, newer SPIAs may include withdrawal provisions or provisions for payment of commuted values or both.
- Except for variable annuities, annuities are not appropriate for those who want a high rate of return. While fixed annuities are considered low in risk, inflation can erode the purchasing power of the income payments.

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- With variable annuities, the owner bears all of the investment risk, but gains the opportunity for greater returns. Variable annuities are appropriate only for individuals who can afford the risk of loss on their investment.
- On the other hand, people who want to know they will receive a predictable income without the worries and concerns of managing their own investments are well-suited for fixed annuities.

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SUMMARY

What Is an Annuity?

An annuity is a contract under which an insurance company agrees to make payments to an individual in return for receiving premium dollars. The person receiving the income may or may not be the owner of the contract. The owner is the person who enters into the contract, typically pays the premium, and is liable for any taxes due on annuity payments.

What Is a Single Premium Immediate Annuity?

A single premium immediate annuity (SPIA) is, as the name describes, purchased with a single premium payment and begins annuity payments immediately. A deferred annuity, on the other hand, begins payments at some future time.

The applicant for the SPIA elects the payment frequency—anywhere from monthly to annually. Income can commence right away or as late as one year from the annuity's issue date.

What Are Typical Sources of the Single Premium?

SPIAs are often purchased by someone who has a substantial sum of money from an inheritance, a life insurance death benefit, a maturing certificate of deposit, or a lump-sum qualified retirement plan distribution.

What Types of Annuities Are Available?

One way to classify annuities is according to the way interest is earned. Fixed annuities feature earnings guaranteed by the insurer. Variable annuities feature earnings allocated to separate accounts that invest in securities and have no guarantees. Indexed annuities feature earnings that reflect the performance of an outside index without investing directly in equities themselves.

How Do SPIAs Work?

A single premium is deposited into either (1) an insurer's general account paying interest at a guaranteed rate, or (2) one or more separate accounts paying interest at a rate that varies with the performance of the underlying investments or, in the case of an indexed annuity, a rate that varies according to the insurer's crediting procedure.

The premium plus the interest earned provide the stream of income—a stream intended to provide income for a lifetime, for a specified period, or for some combination. The amount of each payout depends on the amount of the single premium paid, the period during which payments will be made, the number of payees, and whether or not there is a refund or death benefit.

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How Will Income Be Paid?

A variety of payout options are generally available:

- **A straight-life (or life-only) annuity** stops making payments when the annuitant dies, but has the advantage of providing the maximum periodic payout amount.
- **A joint-and-last-survivor annuity** makes payments until the death of the last annuitant. Sometimes, a reduced payment—often two-thirds or one-half—is made after the first annuitant dies.
- **A period-certain annuity** makes payments for a specified period of time.
- **An amount-certain annuity** pays a specified amount on a regular basis for a length of time that depends on how much is available in the annuity at the start, the interest rate, and the amount of each payment.
- With a **refund annuity**, if the annuitant dies before the full premium is recovered, the insurer will provide either continued income or a lump-sum settlement to a named beneficiary.

How Are Income Payments Taxed?

If the annuity is purchased with tax-deferred funds, each payment will be taxed in full. If the annuity is not purchased with tax-deferred funds, the IRC Section 72 annuity rules allow the tax-free recovery of basis spread over life expectancy. This means only earnings will be taxed, not principal. An exclusion ratio is used to determine the amount of tax due on each payment.

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