RETIREMENT PLANNING

Annuities

"I want to create a stream of income with retirement assets, but I need early access and I'm concerned about the associated penalties."

The Scenario

Christopher Blair realized at an early age the benefits of saving on a regular basis. His first corporate IT position offered him a qualified profit-sharing plan with a 401(k) account and he took full advantage by contributing the maximum allowed under the plan each year. Christopher's skills offered him the opportunity to advance several times in his career, working for three different Silicon Valley start-ups over the years. Each company offered a 401(k) plan, and he dutifully rolled over his balance to his new employer's plan with each successive job.

At the age of 56, his steady advancement came to a halt when his position was eliminated in a corporate merger. His initial bout of depression and furious job hunting slowly gave way to a revelation—he was in a position to retire early. Christopher had done well for himself financially and had no family to support. After serious consideration, he decided to stop looking for another job and instead pursue his passion for ballooning and flying gliders all over the world while he was still young and healthy enough to enjoy it. He even envisioned that down the road, when he no longer felt comfortable pursuing these hobbies, he would like to create a website detailing and rating various flying routes and locations—a second career that would combine his tech background with his passion.

By always investing a portion of his 401(k) assets in company stock, his account has grown to nearly $4.5 million. He assumed that, for ease of management, he could simply leave the money in the plan and take periodic distributions to fund his new ventures. After all, he was retiring, and that is what his 401(k) was designed for. He soon learned, however, that any distribution prior to age 59½ was subject to a 10% early withdrawal penalty in addition to ordinary income tax. This was disappointing information to say the least. He debated whether to leave the money in the 401(k), roll it into an IRA, or take it out as a distribution and pay the tax and the penalty.

CHARACTERS AND CONCERNS

Christopher Blair – An unmarried former IT executive with a substantial profit sharing/401(k) account balance. He decides to retire at age 56 after being laid off in a corporate merger. He needs access to his retirement funds now, but doesn't want to actively manage them or be hit with a big tax bill or penalties for taking money out.

A Planning Strategy

Christopher approaches his financial advisor, Henry Bankovich, for advice on what to do with his retirement assets. Henry begins by clearing up a misconception—while distributions from the 401(k) will be taxed as ordinary income, Christopher will not have to pay the 10% early distribution penalty since his employment was terminated after age 55. For Christopher, this is an important exception to the rule. He is relieved he sought professional advice before rolling his distribution into an IRA, since the exception does not apply in the case of IRAs.

Next, Henry notes that leaving the money in the employer plan would require Christopher to oversee his investments and decide how to take required minimum distributions—both responsibilities he would just as soon do without. Henry proposes annuitizing $3 million of the retirement assets and leaving the remaining $1.5 million in the 401(k).

With an immediate annuity, Christopher makes a single, large payment and starts receiving a steady stream of income right away that will continue for life. He can choose to receive payments annually, quarterly or monthly. This automatically satisfies the IRS rules for required minimum distributions, and the life insurance company that issues the annuity will be responsible for all management decisions, which suits Christopher's needs. Of course, annuities are not flexible or liquid—Christopher can take money out, but would face a significant surrender charge that declines over the first ten years or so of the annuity. This is one reason Henry suggests keeping a portion of the retirement assets in the 401(k).

To reduce the time he will need to spend monitoring the 401(k) assets, Christopher chooses to invest them in a low-risk fund with a track record of modest but solid growth. Since he will still be responsible for taking the required minimum distributions (RMDs) from this account, he obtains the cooperation of the 401(k) plan administrator to copy his accountant on all communications with regard to satisfying the RMDs when he reaches age 73.

MORAL OF THE STORY

Annuities are powerful tools for individuals who want to turn retirement savings into a guaranteed lifetime income stream. The idea of never outliving retirement savings is very important to many retirees, and the retiree can structure the annuity to match the level of risk appropriate to both circumstances and comfort level. Balancing that locked-in strategy with other, more liquid investment vehicles provides a cushion to help deal with sudden expenses.

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