

Getting Ready to Retire: What You Need to Know About Annuities

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Getting Ready to Retire: What You Need to Know About Annuities

The Actuarial Foundation, counting public information among its primary goals, is making available this educational paper to assist individuals who are retired or nearing retirement. The intent is to give retirees a source of information on how to manage their assets over their lifetimes by using annuities and other strategies. Initially, this paper is intended to furnish information for a brochure to be published by the Women's Institute for a Secure Retirement (WISER) as a source of guidance for women retirees.

In exploring the needs and sources for retirement income, the paper touches briefly on many financial planning issues for retirees. For detailed information about such topics as investing, household budgeting, Social Security, pension plans, IRAs, Medicare, Medicaid, Medigap insurance, nursing homes, estate planning, and taxes, readers should consult other sources.

This paper was prepared by a task force of retirement planning specialists, most of them actuaries who are independent of insurance companies and annuity providers. The views expressed are their own, not those of any employer or other institution. There is no professional consensus on some of the matters discussed here, such as the minimum desirable amount of retirement income. Because the paper is meant only for general guidance, persons wanting specific advice suitable for their own circumstances should engage a qualified professional advisor such as an actuary who counsels individuals, an attorney, or a financial planner. © 2002 The Actuarial Foundation

A. Planning Your Retirement Income

1. Introduction

Many Americans use their retirement assets too rapidly and later find they can't afford a decent standard of living. This outcome can be particularly difficult for women because they often live longer than men. Married couples may fail to adequately plan for the time when one of them is gone -- most often, the woman is the survivor. Meanwhile, other Americans are too conservative about investing and spending their retirement savings, and later find they could have lived more comfortably. Retirees need to steer a safe path between these two pitfalls of running out of money or, perhaps a lesser evil, living below the standard they could afford.

Traditionally, employer retirement plans just paid lifetime pensions, giving employees little choice about when or how to receive such benefits. An employer's pension fund could absorb good and bad experience over time, paying benefits as promised even if investment markets did poorly or many participants lived longer than expected. Today, you often must make key decisions about managing your own funds to cope with the 3 big risks after retirement:

- How long will you live?
- How will your investments do?
- How much inflation will you see?

Most financial planning for retirement focuses on getting workers to save and invest wisely during their working years. Little information is available for the years after retirement begins, showing retirees how to take the money out over their lifetimes. No magic formula can give the right answers because each individual and couple enters retirement in a different situation, and their futures will unfold differently. Although the answers will depend on your changing circumstances, needs, and preferences, this paper offers ideas and tools for handling your retirement funds in the 21st Century.

a. What will you do with that retirement nest egg? What choices will you have?

This may be the most important financial issue you'll ever face – the total amount can easily be several times your annual pay. Your retirement savings may be invested in mutual funds, stocks, bonds, or certificates of deposit through a company savings plan or an IRA. Or you may be entitled to take a company pension as a lump-sum distribution. After retirement, even people who are used to investing large sums of money may not know how to make it last a lifetime. You may feel that after it's gone you can always go back to work, but later you may be unable to find a suitable job that you can still perform.

Few retirees appreciate how costly it is to maintain their standard of living for another 20, 30, or more years after they stop working, especially with inflation, medical bills, and other unexpected expenses coming up. You may underestimate how long you'll live, not recognizing that life expectancy is only an average figure and some individuals will live much longer than average. Or you may underestimate how much you can reasonably spend, and go without things you can well afford. You have 2 basic ways to convert your retirement savings to lifetime income, as we'll discuss:

- Make systematic withdrawals -- spending your money at a rate you've estimated will make it last for the rest of your life – and keep investing whatever money you haven't yet spent.
- Use some of your money to buy an annuity -- a stream of guaranteed income payable for the rest of your life or for the joint lifetime of you and your spouse.

You may decide to combine both these methods, managing your own retirement funds until the time is right to convert some assets to an annuity, then tailoring the amount and type of annuity to your own situation.

b. What role should spouses play in retirement decisions?

The married couple approaching retirement should jointly be involved in deciding when to retire, how to spend their lives after retirement, and how to manage the retirement income that will pay their bills. It's important that a married couple together focus on how to use their retirement savings, recognizing their needs as a couple and as individuals. The couple can later be separated by death or divorce (yes, divorces do occur after retirement). This is why private pension plans in America now must give a retiree's spouse the legal right to be paid a survivor benefit unless the spouse has agreed to waive this right.

2. What are your needs for retirement income?

a. How much income will you need after retirement?

"I have enough money to last me the rest of my life unless I buy something." – Jackie Mason

A commonly accepted benchmark is that retirees will need at least 75% of the income they had while working. You won't need 100% of your former pay as some costs will decrease or disappear, including payroll deductions for income tax, Social Security, retirement savings and other benefit plans, along with extra costs of commuting and clothing. Still, some retirement income is subject to tax, and you may have added costs for Medicare Part B, supplemental health insurance, travel, entertainment, hobbies, and gifts. A target of about 75% is built into many of the calculation tools and formulas that tell employees how much they should be saving for retirement in order to maintain the same standard of living they had before retirement. The 75% factor agrees with a 2001 study by Georgia State University and Aon Consulting in which the retirement income targets range from 74% to 78% of pay for employees earning \$30,000 to \$90,000. For example, if your pre-retirement pay is \$50,000 a year before taxes and other deductions, you'll need retirement income of roughly \$37,500 (75% of \$50,000).

A rough target such as 75% of pay, though very useful as a guide for pre-retirement saving, may not fit your own circumstances closely enough. As you get close to retirement, a better way to determine income needs is to sharpen your pencil and draw up a realistic retirement budget based on your expected spending pattern and place of residence. For example, some retirees decide to change their life style, moving to a smaller dwelling or a lower-cost area, or making a major change in their activities. If you develop a retirement budget that's far below the 75% benchmark, be sure you understand the differences and check that your figures include all areas of spending.

b. How long must your retirement income last?

The short answer is -- nobody knows. Life expectancy figures, though meaningful for a large group of people, mean very little for one or two individuals. Here are some things we do know about longevity:

- Longevity increased steadily in the 20th century. We can expect to live even longer in the 21st.
- Women live longer than men on average, and women often marry men who are a few years older, so most wives outlive their husbands.
- Life expectancy is a moving target. As you get older, the age to which you're expected to live goes up as the people in your age group who have died are no longer counted toward the average. For example, in one mortality table, life expectancy at age 65 is 20 years, i.e., to age 85. But those who survive to age 75 can anticipate living to 87.5. And once they reach 85, their life expectancy increases to age 91.5. This moving target of longevity is one reason retirees ought to keep their financial plans flexible.

How long can people retiring now expect to live? Let's look at "best estimate" figures from actuaries at the Social Security Administration, who anticipate that longevity will keep improving in the future. For Americans who reach age 65 in year 2000, the average future lifespan (life expectancy) is 16.4 years for men and 19.6 for women. These averages might suggest that they'll all die in their early 80s, but the averages can be misleading. Out of all men or women who are age 65, here are the percentages expected to survive to the ages shown:

| Survivors to Age | Men | Women |
|-----------------------------|------------|--------------|
| 65 | 100% | 100% |
| 70 | 88 | 92 |
| 75 | 74 | 82 |
| 80 | 56 | 69 |
| 85 | 36 | 51 |
| 90 | 17 | 31 |
| 95 | 6 | 13 |
| 100 | 1 | 4 |

For example, about half the women (51%) are expected to live past age 85, and 1 out of 8 (13%) will live beyond age 95. The same numbers tell us that some 65-year olds will live many more years while others will not. Here is the distribution of their expected future lifespans after age 65:

| Future Lifespan After Age 65 | Men | Women |
|---|------------|--------------|
| Under 10 years | 26% | 18% |
| 10 to 19 years | 38 | 31 |
| 20 to 29 years | 30 | 38 |
| 30 years & up | 6 | 13 |
| Total | 100% | 100% |

Thus, life expectancy is just an average figure that doesn't apply to an individual. Many retirees survive into their 80s and beyond. This proportion is growing as longevity keeps improving. Current retirees in good health should be prepared to live into their 90s.

c. What about inflation?

After you retire, prices for almost everything you buy will probably go up. Inflation is a major risk for retirees that's very difficult to predict. In recent years, the average annual rates of inflation were:

- About 3% in the 1990s
- About 5% in the 1980s
- About 7% in the 1970s

Over time, such rates of inflation can make a big difference in what you'll be able to buy with a fixed income, as in these examples:

| Annual rate of inflation | Purchasing power of a fixed \$10,000 retirement income | | | |
|-------------------------------------|---|-----------------------|-----------------------|-----------------------|
| | At retirement | After 10 years | After 20 years | After 30 years |
| 3% | \$10,000 | \$7,441 | \$5,537 | \$4,120 |
| 5% | 10,000 | 6,139 | 3,769 | 2,314 |
| 7% | 10,000 | 5,083 | 2,584 | 1,314 |

Do employers adjust pension benefits to keep pace with inflation after retirement? Practices vary widely. Private firms usually don't increase pensions after retirement except in certain older industries such as auto and steel. Many large public employers, including the U.S. government and some state-local governments, increase pensions after retirement by using an automatic indexing formula or by routinely granting annual increases. Social Security benefits have annual cost-of-living adjustments. Perhaps most of your retirement income will come from retirement programs that have such built-in increases. If not, inflation is a serious risk you need to consider when investing your money.

A fairly common attitude is "I'm not taking any chances with my retirement money, so I'm keeping it in CDs or a money market fund." This may seem safe, but beware. Investments with stable values that appear safe in the short run can be dangerous over time -- especially when you're trying to keep ahead of inflation. As this table shows, conservative investments suffer most from the effects of inflation.

| Average annual investment return, 1926-1998 | | | |
|---|------------------|-------|--------|
| | Cash investments | Bonds | Stocks |
| Total return | 3.9% | 5.7% | 11.2% |
| Average rate of inflation | 3.1 | 3.1 | 3.1 |
| Net return, after inflation | 0.8 | 2.6 | 8.1 |

Over time, cash and other conservative investments with stable values have produced the smallest net return after factoring in inflation. Stocks, on the other hand, offer the highest potential for keeping ahead of inflation. Of course, stocks are very risky; over short periods, their prices may decline, sometimes sharply and suddenly. But over the long term, stocks historically have outperformed other investments.

It's true that past results are no guarantee of future performance. Yet, unless the future is totally unlike the past, stocks have an important role to play in your investment strategy for retirement. It may help to think of your employer pension and Social Security benefits as a solid base to build on, similar to income from bonds. Knowing you can count on getting that basic income even if the stock market were to drop substantially, you can feel more comfortable about investing other assets for growth.

A few other anti-inflation strategies may be available to retirees besides common stocks or automatic increases in pensions and Social Security benefits:

- Optional forms of annuities or pensions with automatic annual cost-of-living increases such as a flat 3 percent or the percentage increase in CPI. These inflation-protection features are not often used because their cost may seem high, even with realistic assumptions.
- Inflation-indexed Treasury bonds or inflation-indexed annuities. These are new, not yet widely accepted.
- Variable annuities invested in a stock market portfolio, which retirees can purchase to provide immediate income. Variable annuities require very careful shopping, as high costs and fees are a potential problem.

d. How will you pay for health insurance?

Don't overlook the costs you and your spouse will pay to replace any employer health insurance you may lose at retirement or at age 65 when Medicare takes effect. Here are some points to consider:

- When your employer health insurance stops, you usually can continue it yourself for 18 months by paying a group rate (for so-called "COBRA" coverage). If you won't have health insurance from another job, when COBRA coverage ends you'll probably want to purchase individual health coverage until age 65 when Medicare begins.
- Medicare Part B premiums (\$45.50 a month in 2000) will reduce your Social Security benefits. Medicare will pay part of your bills for hospital care (under Part A), doctors' services (under Part B), and many other items including home health care in some situations. When Medicare covers an expense, you must take care of any deductibles, coinsurance, or costs that are beyond Medicare limits.

- At age 65, you can buy a Medicare supplement (“Medigap”) policy to help pay these other covered expenses plus some bills that Medicare won’t pay at all, such as for prescriptions or treatment outside the U.S.
- You still will have to pay some medical bills that fall outside of Medicare and Medigap, such as for dental care, eyeglasses, and hearing aids.
- Medicare makes available several other options including Health Maintenance Organizations (HMOs) that can replace both Medicare and Medigap.
- Health care costs have generally risen faster than the CPI. Before reaching age 65, you may want to start getting data from agents or from the Internet on rates for Medigap policies available in your state through insurers or organizations such as AARP and Blue Cross-Blue Shield.
- As noted in the next section, Medicare and Medicaid won’t pay for long-term custodial care in a nursing home, so you may also want to buy long-term care insurance.

e. How will spending needs change if your health changes?

If you or your spouse needs medical or personal assistance, becomes frail, or can’t get around unaided, your spending pattern and life style will change. For example, people over age 85 spend less on travel and other outside activities, while spending more on medical bills and health-related personal care. Elderly women living alone are the most likely to need long-term care on a paid basis. Medicare and health insurance plans don’t cover such costs, and even a long-term care insurance policy covers only part. The percentage of the population needing help for some sort of disability increases with age, as shown in this table:

| Age Group | Percent who need some help for long-term disability | Percent who are severely disabled* |
|-----------|---|------------------------------------|
| 65-74 | 12% | 3% |
| 75-84 | 27 | 9 |
| 85 & over | 60 | 32 |

*Unable to perform at least 3 Activities of Daily Living or institutionalized (1994 data)

Source: Eric Stallard, *Retirement and Health: Estimates and Projections of Acute and Long-Term Care Needs and Expenditures of the U.S. Elderly Population*, Society of Actuaries Retirement Needs Framework monograph (Monograph RS99-3, January 2000), Figure 3.

What about getting Medicaid to pay for long-term care? Medicaid is available only if you are “poor” as defined by law. The program has limits on what care is paid for and when. Some people spend down all their assets and then become eligible for Medicaid. This often is not a preferred choice, as the type of care available may not be what you would choose. Moreover, it may pose legal or ethical issues. For example, if a couple’s assets are all spent down before the first one dies, the survivor will be left in poverty except to the extent that annuity income or life insurance is available. For this reason, the healthier spouse may eventually want to consider purchasing an annuity.

Individual situations among the elderly vary widely. You should expect to require more income as you get older, especially if you have no solution in place to cover a possible need for long-term care. If you become frail and aren't yet eligible for benefits from long-term care insurance, you may need extra income or assets to pay someone to care for you.

f. Survivor issues: Do you help support or take care of someone else?

Does someone else in your family rely on your income to cover living costs? Do they need your ongoing personal help -- with shopping, housework, taking medication, cooking, etc. -- but not at the level provided by long-term care facilities? What happens to them if they live longer than you do?

A married couple may cope very well as long as one of them is healthy. But if the healthier person dies first, the survivor may be much worse off unless a child or neighbor can step in promptly to provide personal care. A surviving widow may have to purchase the services needed by selling her home and moving into costly specialized housing. Married couples need to give serious thought to this issue, especially the prospect of widowhood. Widows are over three times as likely to be poor as older married couples. A couple will need regular income as long as either one is alive.

Start by considering the pattern of income you and your dependents will need. Research suggests that an individual needs 75% of the income of a couple to cover basic needs. Many of your monthly bills will keep getting higher with inflation, especially as medical care expenses grow, though some expenses decrease when you become less active.

Next, consider other possible sources of income to your survivors:

- **Pensions:** Does your employer pension pay survivor benefits after your death? In a private retirement plan, a married retiree must provide his or her spouse at least a 50% survivor benefit unless the spouse signs a form waiving that right. While some public pension plans also require the spouse's consent when a retiree chooses a single-life option, federal law does not require this.
- **Social Security:** Social Security may pay benefits to your spouse, to children who are young or disabled, or to certain other family members. Note that someone who has already earned a substantial benefit by working under Social Security often won't get a greater benefit as a surviving spouse, as that program pays only the larger of the amounts available to a worker or a surviving spouse, not the total of both amounts.
- **Insurance:** Will proceeds from a life insurance or long-term care insurance policy help your survivors maintain their living standards?

3. What are your sources of retirement income?

Before deciding to retire, you'll want to add up your expected retirement income from all sources. The table below will help you see whether each kind of income is one that you can count on getting for life, and whether the income is fixed or has a good chance to grow and keep up with inflation.

Add Up Your Sources of Retirement Income

| Source of income | Monthly amount | Can you count on getting the income for life? | Will the income keep up with inflation? | Can some or all of the income continue to your surviving spouse? |
|---|----------------|--|--|--|
| A. Social Security | \$ _____ | Yes | Yes | Yes, offset by other Social Security benefits payable to the survivor |
| B. Employer pension – if paid as monthly income | \$ _____ | Yes | Private plans usually won't. Public employee plans often will. What is your plan's track record? | Yes, if you use a joint and survivor form |
| C. Employer savings plan account – if paid as guaranteed monthly income | \$ _____* | Yes | Not usually. Amount is fixed unless you use a variable or indexed annuity. | Yes, if you use a joint and survivor form |
| D. Employer pension or savings plan account – if paid in a lump sum that's rolled over to an IRA and invested | \$ | Some risk of running out of money, depending on how well you manage investments and spending | Depends on performance of your investments and the economy while you're retired | Depends on how well you manage investments and spending during your lifetime |
| E. Part-time work | \$ _____ | No. In later years you're unlikely to find a suitable job that you can perform. | Probably, as long as you keep working | No |
| TOTAL FROM ALL SOURCES: | AMOUNT: | HOW TO CALCULATE TOTAL AMOUNT: | | |
| • Initial income | \$ _____ | Add A, B, C, D, E | | |
| • Income you can count on for life | \$ _____ | Add A, B, C | | |
| • Income that can keep up with inflation | \$ _____ | Add A and E, maybe B, C, D, | | |
| • Income that can continue to your survivors | \$ _____ | Add A, B, C, maybe D | | |

* First estimate the lump sum amount you'll have when you expect to retire. Then convert that amount to an immediate monthly income based on 1/12 of the annual income factors given in Appendix D.

What if your total expected income falls short of your needs? You have several ways to fill the gap:

- Stay on your regular job a little longer to earn a bigger pension or accumulate more savings
- Plan to supplement your pension temporarily by working part-time or full-time
- Consider ways you can spend less, such as by moving to a smaller home or a lower-cost area
- If you own your home, look into a reverse mortgage that can produce income without forcing you to move

4. How should you take money out of your retirement savings?

In planning how to spread your retirement savings over the years ahead, neither outliving your assets nor holding down your standard of living needlessly, you may want to consider these 3 alternative strategies.

1. Make systematic withdrawals, spending your money at a rate you've conservatively estimated will make it last the rest of your life and investing the balance until you need it.
2. Convert some of your money to a stream of guaranteed income payable for life and invest the balance until you need it.
3. Combine both these strategies, waiting to buy an annuity until you're at least age 70.

Strategy #1: Establish a conservative withdrawal program for your retirement savings

With this strategy, you'll have to tap into your retirement savings to pay your expenses in retirement. By creating a budget and comparing it to your regular sources of retirement income, you'll easily see the "gap" of additional income you need — and you may decide to fill this gap by withdrawing a set amount or percentage from your retirement savings each year. This method gives you the freedom to invest your money as you wish and the flexibility to respond to needs or opportunities that may arise. For example, many of today's popular investment ideas such as index funds, international funds, certificates of deposit, and money market funds were unknown only a few decades ago; you can expect other new concepts and products to become available in the years ahead. Note that you can easily change this strategy if purchasing an annuity begins to look attractive as you get older.

If you use this approach, be careful not to withdraw too much money in any one year -- especially early in your retirement. Too much money withdrawn at any one time will deplete your retirement savings.

Although many current retirees are using this method, at least initially, managing a withdrawal program is harder than it looks. Your strategy may look fine on paper based on historical averages about the economy, life expectancies, and so forth, but real life is full of surprises. That's why you need to be conservative and to redo your plan at least every few years.

Strategy #2: Use some of your assets to purchase an immediate income annuity

To eliminate some of the uncertainty, you can apply part of your funds to buy an immediate income annuity, or have your company pension paid as a monthly income. An income annuity will convert part of your retirement savings into a stream of monthly income that lasts for the rest of your life, no matter how long you live. Immediate income annuities can be another "building block" of income that you can't outlive, on top of other sources of income that are typically considered the foundation of a retirement income plan.

Strategy #3: Wait to buy an annuity until you're at least age 70

Instead of purchasing an annuity from an insurer at the time you retire, you may want to manage your own money until you're older, then buy an annuity. This strategy preserves more flexibility to deal with changes that may occur and recognizes that an insured annuity provides more valuable longevity insurance at advanced ages. In other words, you could choose to self-insure the longevity risk until age 70 or beyond, then buy an annuity if you are in good health.

5. If you elect a lump sum from an employer pension plan, will you lose valuable benefits?

Before electing to convert your monthly pension to a lump sum distribution, find out if you'd be giving up valuable benefits that are available to ongoing annuitants, for example:

- Early retirement pensions that are “subsidized” may be substantially more valuable than the lump sum you could get as an alternative, especially for long-service employees at age 62 or earlier. Early retirees should ask whether the early retirement pension available to them is subsidized (i.e., is the amount of pension greater than the actuarially reduced amount of pension payable at normal retirement age that you have earned to date, or is reduced actuarially?) and whether the lump sum reflects any such additional value or subsidy. Although the underlying numbers use complex assumptions and methods that you can't expect to fully understand, you deserve an intelligible explanation of this important point.
- Retiree health insurance coverage may be available only to a current retiree (and spouse), not to a former employee who has taken a lump sum distribution. Such plan provisions vary among employers, so it's important not to make assumptions.
- Private pension plans must use unisex rates to calculate lump sums that are the same for men and women, although women tend to live longer on the average. This rule makes electing a lump sum instead of a pension a little less attractive deal for a woman than it would be for a man.
- Automatic cost-of-living adjustments in pension amounts may be given only to ongoing retirees. You should try to find out whether the lump-sum amount you would get includes a realistic assumption for the value of any future COLAs that you'll miss out on.
- Periodic (“ad hoc”) pension increases generally go only to ongoing retirees. The lump sum amount you get is unlikely to include anything for such increases as they are not automatic.
- Other extra benefits for ongoing retirees vary widely. Some telephone companies give retirees free telephone service. A large public employee retirement system allows annuitants to pay for retiree health insurance from accumulated sick leave, which they would forfeit if they took a lump sum.

B. Annuities: Overview

This discussion deals only with *immediate life annuities*. This is the kind of annuity you might decide to buy at or after retirement, with income payments that begin right away and continue for life. We won't discuss *deferred annuities*, which are designed to help you accumulate funds over the years before retirement, or *special kinds of annuities* that pay income only for a limited time, that let you make lump-sum withdrawals, or that you get through a charitable institution. Thus, in the discussion that follows, "annuity" means either an immediate life annuity purchased from an insurer or a pension plan benefit that's paid out as a stream of lifetime income.

Don't put all your money into an annuity, as annuities usually don't allow withdrawals for unexpected expenses once annuity income begins. Also remember that an annuity pays you both principal and earnings.

Thus, you get a high guaranteed cash flow but your heirs may receive considerably less than if you hadn't used an annuity.

1. Why might you want to buy an annuity?

An annuity lets you convert all or part of your retirement savings to a guaranteed stream of lifetime income, giving you a form of security that traditional investments can't. You can buy an immediate annuity with funds available from a 401(k) plan, IRA, savings account, life insurance policy, inheritance, or the sale of a home. Annuities are not for everyone, but they can be very helpful in securing retirement income by letting an insurance company bear the risk that you'll live many more years.

An insurance company that you select invests the money and makes regular payments, either by check to you or by automatic deposit to your bank or financial institution, every month, quarter, half-year, or year for as long as you live. Although you'll have the security and assurance of an income that you can't outlive, it's important to understand that typical annuities don't allow you to take any lump sum withdrawals once income payments begin.

An annuity can be designed to provide an income tailored to your own needs, with the amount of income you'll get determined at the time of purchase. The amount of income is based on a number of factors including your age, sex, purchase amount, income option selected, and interest rates at the time of purchase (or investment performance of portfolios you choose). The income payments can stay level or can gradually increase to offset inflation.

2. What are "fixed" and "variable" immediate annuities?

There are two distinct types of immediate life annuities, each providing a regular stream of income after your initial purchase.

A *fixed annuity* means the insurance company promises to pay you a certain amount of income as long as you live. The insurer invests the money it gets from you in fixed-income securities such as bonds and mortgages and pays you a specific amount each month. A fixed annuity generally will not adjust your payments to keep up with inflation. Some insurers do offer a fixed annuity with payments that automatically go up each year by a specific percentage, or that keep pace with inflation. In that case, your income payments will start out much lower than under an annuity that has constant payments – in other words, an annuity with automatic increases has a substantial extra cost. A fixed annuity is typically used to get the peace of mind that goes with guaranteed lifetime payments.

A *variable annuity* means that the insurance company promises to pay you income as long as you live, but the amount of income is not guaranteed. Rather, your income goes up or down based on the investment return of a common stock portfolio that you choose. Over time, with favorable returns your

income payments would increase and tend to protect you against inflation. During the past century, the stock market has gone up over any extended period of years. But stock values often have declined, especially in the short run, and you have no guarantee that future returns will be favorable or that annuity payments will increase. Thus you may want to buy a variable annuity to get lifetime payments that have an opportunity to go up, mindful of the fact that variable annuity payments can also go down.

3. How does an annuity compare to other income alternatives?

a. What are advantages and disadvantages of purchasing an annuity?

Other methods are less certain than annuities, though they give you more control over your money. You'd have to make systematic withdrawals from savings and investment income, using estimates of how much you can afford to spend each year over your lifetime. But nobody knows how long you'll live, how well your investments will do, or how much inflation you'll see, so you must use educated guesses. Even if your economic assumptions hold up over the long run, your investment return may fluctuate greatly from year to year. And after age 70 ½, your withdrawals from funds invested in a 401(k) or traditional IRA must also satisfy IRS rules for minimum annual withdrawals; an immediate annuity automatically satisfies such rules.

On the other hand, the price of an immediate annuity covers several insurance company items that you may not want to pay for. This price, which includes expenses ("loadings") for the insurer's marketing and ongoing administration, uses conservative assumptions for longevity which recognize that only the healthiest people tend to buy an immediate annuity, and uses assumptions for investment return which are based on investment in fixed-income securities such as bonds and mortgages. Moreover, buying an annuity from part of your assets gives up flexibility to invest in equities which historically have higher yields, to use the money for major expenses, or to refrain from buying an annuity should your health suddenly deteriorate. Still, in some situations you may be perfectly willing to commit some funds to buy an annuity.

Insurance was invented so that people could transfer to an insurance company a risk that seldom occurs but is potentially very costly. Accordingly, high deductibles make sense in some kinds of policies – why pay an insurer to cover routine costs that are more or less predictable, which you can plan for and self-insure? You may want to view an annuity as insurance against living to a very old age and choose to self-insure the portion of your life up to about 70 -- an age the vast majority of retirees will attain. For younger retirees, buying an annuity may not produce much more current income than simply investing in fixed-income securities. The picture changes as you get older and find that an annuity pays substantially more current income than other fixed-income investments. Research in this area is incomplete but clearly supports the concept that an insured annuity is more useful at older ages. Waiting until at least age 70 to buy an annuity often is a good strategy as older retirees may be more concerned about outliving their assets but less concerned about future inflation. Note too that buying an annuity by age 70 ½ has the advantage of satisfying IRS rules for minimum required distributions.

The next table briefly compares two alternative strategies (1) keeping all your savings invested while taking money out systematically over your lifetime, or (2) using part of your retirement savings to purchase an immediate annuity.

Taking Your Money Out: Comparing Two Strategies

| | Systematic Withdrawals | Immediate Annuity |
|--|---|--|
| How does this method spread income over your life? | You take money out whenever you wish. You may run out of money if you live “too long” or your financial plans don’t work out. Or, if your planning is too conservative, you may live below a level you could afford. But this method lets you leave money to heirs if you live only a few years or your investments do very well. | An insured annuity converts some of your assets to retirement income that’s spread over your future lifetime, no matter how long you live or what the economy does. To the extent you convert assets to an annuity, you’ll eventually “die broke,” leaving nothing to heirs. Part of the price you pay covers the insurer’s costs of marketing and ongoing administration. |
| Does it protect you against inflation? | Common stocks have historically been the best long-term anti-inflation strategy, although values can decline sharply in the short run. You also can invest in Treasury bonds indexed to the CPI. | Fixed annuity payments will lose purchasing power with inflation. Payments from a variable annuity will vary with stock market results, and over time may keep up with inflation or outpace inflation. |
| Is it flexible enough to meet your individual needs? | You have complete control over investment and withdrawal of funds as your circumstances and the economy change (subject to IRS rules for 401(k)s and IRAs before age 59 ½ or after 70 ½). Also, you can buy an annuity any time. | You can buy an annuity with payments that run for a minimum number of years, or that continue after your death to a joint annuitant. But the terms of an annuity contract are not subject to change once it’s issued. |
| How do you handle investing, bookkeeping, income taxes, and IRS compliance? | You must manage your investments and withdraw enough income to pay your bills. Taxable income may vary greatly with annual investment results. After age 70 ½ you must be careful to take out the minimum required distribution each year based on IRS rules. | The insurer invests the money and sends monthly payments to your bank account or financial institution. The amount of your taxable income each year from an annuity is simple and predictable. After age 70 ½, an annuity will automatically satisfy IRS rules for minimum distributions of the assets involved. |
| Who may not be happy using this method? | Don’t use this method if you’re uncomfortable about being responsible for the risks and rewards of managing your assets. Some investment methods let you avoid choosing individual stocks or timing the stock market. But you must decide how to allocate your assets and use various funds and services. | People in poor health probably won’t get their money’s worth from an annuity. Younger retirees can get almost as much income from long-term bonds instead of annuities, and they may prefer equity investments to protect against inflation. Buying an annuity makes the most sense for someone who’s older, in good health, and ready to transfer to an insurer the job of managing assets. |

b. What are some practical ways to take money out of your retirement funds?

Systematic withdrawal methods work best for individuals whose retirement savings are more than adequate to cover their normal spending, leaving room to deal with the unexpected as the future unfolds. Here are just a few of the practices that retirees follow in making systematic withdrawals from savings.

- *Basing withdrawals on your life expectancy* is one way, as you plan to spend a fixed amount of principal and interest each year over the expected number of years. This method may turn out very badly. Even if you can predict how your investments will perform, a problem is that life expectancy is an average figure for a large number of people, with about half of them living longer. So this method may work for the half who don't live past their life expectancy, but the other half will go on living after all their money is spent. A better way is to assume you'll live long beyond your life expectancy, and along the way review your withdrawal strategy at least every few years.
- *Withdrawing just the investment income*, keeping principal intact, is another way often used. This may work for a while, but it has long-term weaknesses. You may overemphasize fixed-income investments that give you stability and high spendable income instead of growth. When interest rates fall, so will your spendable income unless you dip into principal. Eventually, even moderate rates of inflation will shrink the standard of living you can afford. This method may work for older retirees who are no longer concerned about the long term. Younger retirees may want to balance their investments at retirement between income and growth, planning their spending without making a sharp distinction between principal and investment income, and redoing their spending plan periodically.

Let's compare a fixed income annuity against two simple alternatives. We'll assume you're 65 years old with a \$100,000 retirement fund to generate income, and you can earn a 6% return after all investment expenses.

| Investment Method | Annual Income |
|---|---------------|
| Live off interest only and keep principal intact. | \$6,000 |
| Withdraw principal and interest in level amounts over 25 years. (You have about a 25% chance of living longer than 25 years and thus outliving the savings.) | \$7,820 |
| Purchase an immediate income annuity. Income is paid as long as you live and ceases upon death. | \$7,940* |

* This amount is based on 6% interest and representative male mortality (1983 Individual Annuity Table). The above numbers are hypothetical and do not reflect actual annuity pricing.

These figures will change if we use different assumptions but they illustrate two basic points. First, you get more spendable income from your retirement savings by withdrawing amounts that include principal as well as interest. Second, in a retirement strategy that uses both principal and interest, an annuity removes the risk that you may outlive your savings.

Such figures give only part of the retirement income picture – you still must consider how to protect against inflation, loss of your health, and the chance that your dependents may outlive you. Also, you may want to consider how long you'll be able to manage investments effectively as you get older.

4. How much of your retirement income should come from an annuity?

This is another question with no single answer – annuities will fit one person’s unique situation and temperament better than another’s. Here is a process that may help you decide by focusing on your needs.

First, establish a base level of retirement income according to your own level of expenditures and life style preferences. You can do this several ways:

- **“No frills:”** The poverty level in 2001 is \$8,590 of annual income for individuals living alone and \$11,610 for couples, according to the U.S. Department of Health & Human Services. (Other figures from the same source indicate that an individual needs about 75% as much income as a couple.) If feasible, your basic retirement income should be at least 150% of the poverty level – in 2001 dollars, this is \$12,885 for an individual and \$17,415 for a couple. You’d be able to pay for life’s necessities but not many extras.
- **“Refocus:”** Another way to see how much basic income you’ll need is to establish a budget that takes into account the expenses you anticipate as a retiree. For example, you may be ready and willing to move to a smaller home or a less-expensive area.
- **“Aim high:”** You may be unwilling to retire with a reduced standard of living. For many people who spend nearly all their take-home pay, retirement income equal to at least 75% of your gross pre-retirement income is what works to maintain your living standard in retirement. This is a rough starting point that you should refine by drawing up an estimated budget to pay for annual household expenses of all kinds. Be sure to include a proportionate share of long-term costs such as a new car and major home maintenance.

Next, add up the guaranteed income that will be available to cover your basic needs (and those of your spouse) as long as either of you is alive. First, determine what income you expect from Social Security. That amount will cover part of your base guaranteed income. Then determine what income you can expect from pension plans in which you participate. Annuity income from pension plans often is a better deal than an annuity you can buy in the open market, especially for women because of unisex rates.

If your pension plus Social Security fall short of providing enough minimum income, you may wish to consider buying an annuity to get more guaranteed retirement income for you and your spouse.

If these 2 sources do provide enough, then you should re-evaluate at least every 3 years.

Make sure you’ve considered how to protect against major financial risks you’ll face as you look forward to many years in retirement:

- Inflation may make prices go up faster than your income does
- Your savings and investments may fall in value or start to produce less income
- You may lose your ability to care for yourself or to make complex decisions
- Your spouse or other dependents may outlive you
- You may have unexpected medical or other needs
- Your parents or adult children may need help that you wish to provide

An annuity can pay for long-term care or life insurance, with annuity payments going directly to an insurance company to pay premiums for such coverage. Using an annuity can ensure that payments are made on time, thus removing any concern about lapsed coverage due to missed premium payments. It's important to note that an insurer usually can raise rates for an existing long-term care policy if the increase applies to an entire class of policies. Some insurers now offer an arrangement that combines an annuity and long-term care insurance from the same company, which can be a better deal than buying the two products separately, but this combination requires very careful shopping.

C. Annuities: Practical Issues

1. When is a good time to consider purchasing an immediate annuity?

Normally this decision will come at the time of retirement or later. In fact, retirees will have several good opportunities to consider whether they want to begin getting an annuity.

At your retirement: Workers who retire under an employer pension plan may be able to elect whether to take their benefits as a pension or a lump sum. The employer plan may give you a better deal than if you rolled over the lump sum to an IRA to purchase an annuity on your own, especially after you consider any valuable benefits you get as an ongoing retiree, as discussed earlier.

When you retire from another job: When you change jobs, you may wish to defer the decision about buying an annuity. For example, if you retire at age 59 and take another job, you may simply leave your 401(k) balance in the employer plan, or roll it over to another plan or IRA. Then, if you stop working at age 67, you can evaluate the decision at that time. Your assets will have grown with investment earnings for 8 more years, and annuity rates will be more favorable at age 67.

At your spouse's retirement: If you and your spouse don't retire at the same time, you both may wish to defer a decision about a possible annuity purchase until the second person retires. At that time, be sure to pay attention to what benefits will be available after the first spouse dies.

As you approach age 70 ½: Under IRS rules, minimum annual distributions from a qualified plan or IRA must commence by April 1 of the year following the year you reach age 70 ½. This is another good time to consider an annuity, which is one of the ways to satisfy the rules for minimum distributions.

Between ages 70 and 80: As discussed earlier, when you get older an annuity purchase provides more valuable insurance against living too long. Up to at least age 70, self-insurance of the longevity risk can be an attractive strategy.

In stages, using multiple annuities: A reasonable strategy is to consider buying additional amounts of annuity every few years. That is, if you convert some assets to an annuity at age 65 to provide an income of \$1,000 per month, you may wish to add to that later. At age 68, you can buy an additional \$200 per month, then at age 71 buy another \$200 per month, etc. You can "layer" annuities in this fashion as you get older to recognize that you have less concern about future inflation, your annuity rate is getting better with age, and you may have less interest or ability in managing your own investments. This method also may appeal to someone who believes that the value of his or her 401(k) account is down temporarily and will bounce back, or that long-term interest rates will rise and reduce the cost of an annuity.

Don't convert all your assets to annuity income. You always want some money for emergencies or for special uses such as to provide extra care when you are ill.

2. What optional forms of annuities are available?

How can an annuity also protect your spouse or other dependents? An optional form of pension or annuity can include lifetime benefits for a survivor, or can guarantee payments for at least a minimum period such as 10 years if you die soon after payments begin. Points to consider:

- Is the other person an adult in reasonably good health? If so, consider electing a “joint and survivor” feature when your pension or annuity payments begin (you generally can’t make this change after the payments begin). You pay for this survivor benefit by taking a reduction in your own benefit payments, perhaps 8% to 20%, depending on your two ages and the percentage of your benefit the survivor would get (from 50% to 100%) after your death.
- Is the other person your parent in the final years of life, or a teen-ager who should be self-supporting in a few years? If so, consider electing the “Life with 10 years certain” option, an inexpensive way to cover such a temporary need. The reduction in your annuity or pension may be under 5%.

The table below outlines several annuity options that are commonly offered. The amount of income you can purchase with a given sum of money, \$100,000 in these examples, reflects the cost of any survivor benefits. It’s important to understand that all these examples would change as interest rates and other factors change. The purpose of the table is to illustrate roughly how big a percentage reduction in income you might get by electing one or another kind of survivor benefit at age 65. The reduction is less for a younger annuitant, and greater for an older one.

A. Income Options for an Annuity or Pension

| Income Option | Description | Common Uses | Illustrative Monthly Income * |
|--|--|---|--|
| Lifetime Income. Also called Life Income or Life Only. | You receive income payments for the rest of your life. The income ceases upon your death. | Provides the most income per dollar invested of any lifetime option. Often used by single people with limited sources of additional income. | \$794 per month for life. |
| Lifetime Income with a minimum number of payments guaranteed. Also called Life With Period Certain. | You receive income for the rest of your life. If you die before you receive a specific number of payments, your beneficiary will receive the balance of the number of payments you choose. Often the “period certain” is 10 years. | Consider this option if you want a life income but dislike the risk of lost income in case of premature death. People with heirs often consider this option. | \$754 per month for life, with 120 month minimum. This is about 5% lower than if you elected only Lifetime Income. |
| Lifetime Income with a minimum amount of payments guaranteed. Also called Life With Refund Certain. | You receive income for the rest of your life. If you die before you receive the amount you paid in, your beneficiary will get further payments until total payments equal the amount paid in. | Provides a guaranteed return of principal in addition to life income. Used by people with heirs or those in below-average health. | \$743 per month for life, with 135 month minimum. This is about 6% lower than if you elected only Lifetime Income. |
| Lifetime Income for two people. Also called Joint and Survivor. | Income is paid as long as either of 2 people is alive. At the death of either person, income continues as a percentage of the original amount. Common percentages chosen for the survivor are 50%, 66 2/3 %, and 100%. | Often chosen by couples. 100% option often is used where there is little other income. | \$646 per month, as long as one person is alive, assuming you choose the 100% option. This is about 19% lower than if you elected only Lifetime Income. |

* Assumes a 65-year-old man with a 65-year-old wife invests \$100,000 and begins receiving income immediately. These figures are based on 6% interest and representative mortality (1983 Individual Annuity Table). Your actual income may be different. Only a part of each payment would be taxable.

Other kinds of annuity options, sometimes used to protect against inflation, provide automatic annual benefit increases that are indexed to inflation. The design, cost, and availability of such annuity forms vary widely.

3. How do you shop for an annuity?

If you purchase a *fixed immediate annuity* from an insurance company, your monthly income payments will depend on your age, sex, purchase amount, and current interest rate assumptions. Because different insurers use different methods to figure their annuity rates, you'll find that the amount of income you get will vary from one company to another. Rates are competitive and change often, so it pays to shop carefully.

When you're shopping for a *variable immediate annuity*, you'll want to ask about the annual annuity charge as well as any other fees. And because your income will be based on investments that you choose, you'll want to be sure the annuity offers a choice of investment options with strong track records. Variable annuities can be hard to shop for, but it's important to do this carefully. Different products and approaches have different expected investment returns and expense charges embedded in them. Compare the costs and features in different products. For example, expense rates in variable annuities sometimes are high. Look for products with low loads or low expense charges. The Securities and Exchange Commission has issued a bulletin "Variable Annuities: What You Should Know" to warn consumers about high costs of some variable annuity contracts, as noted in Appendix A.

Here's a checklist you can follow in shopping for an annuity.

- ◆ **How's your health?** Life spans continue to increase because of improved medical practice and personal health habits. Remember the main reason to consider purchasing an immediate annuity is that you're concerned about possibly outliving your savings.
 - If you (and your joint annuitant, if any) are in reasonably good health for your age, you may well find that an annuity makes sense.
 - What if your own health is not so good? Then an annuity is less likely to be a good buy unless you use a form with generous survivor benefits. Alternatively, some insurers have begun offering "impaired life" annuity rates, giving a better deal to annuitants who have a medical condition that may shorten life, such as diabetes or heart disease.
- ◆ **Use a strong insurer:** Use a life insurance company that has a strong financial rating. The annuity business is a long-term arrangement, and you want a company that will always be around. Several insurance company rating services measure financial strength (see Appendix), and your public library can help you check rating information. You may want to get sample contracts to compare among insurers and ask them questions about anything you don't understand.
- ◆ **Find good rates:** For fixed annuities, comparing rates among different insurers requires little paperwork and no physical exam. For variable annuities, cost comparisons are much more complex but are important, as noted above. You can use a trusted agent, accountant, actuary, or tax professional, the Internet, or personal contact. Start shopping before you're ready to buy, getting a sense of what the stronger companies are offering, and don't worry if you soon find all the prices have changed a bit (perhaps for the better as you get older). Don't be in a hurry to buy an annuity just to lock in "today's high interest yields," as it's possible to place your money in alternative investments temporarily to lock in current interest rates until you're ready to decide on an annuity.

- ♦ **Seek other help:** Your state insurance department won't recommend an insurer, but can be very helpful in clearing up any problems you have with a specific company or representative. Each state also has a guaranty fund to protect individuals in the unlikely event an insurer becomes unable to pay benefits in full. You may want to find out how this fund would cover your annuity contract, including any dollar limits that apply; some of these state funds do not guarantee an insured annuity value that exceeds \$100,000.

4. What tax issues should you consider?

This discussion highlights certain tax rules for general guidance. Individual taxpayers, especially those with high income, should consult a qualified tax advisor for specific advice that applies to their own case.

a. How is a pension or annuity taxed?

Federal income tax treatment of a pension or annuity depends on whether or not the recipient has contributed "after-tax" dollars toward the cost:

- **Pre-tax dollars:** If an annuity is purchased entirely with "before-tax" dollars, the benefits are fully taxable. This rule applies to benefits from a public or private pension plan that has no employee contributions, a 401(k) account accumulated from employer contributions or employee deferrals, or a traditional IRA funded by deductible contributions or rolled over from an employer plan (not a Roth IRA).
- **Post-tax dollars:** If the individual taxpayer contributes "after-tax" dollars toward the cost of the annuity or pension -- for example, from personal savings held outside a pension plan -- the taxpayer later gets back benefits equal to these contributions (or "basis") as tax-free benefits over his or her life expectancy based on IRS actuarial tables. Because the individual's contributions have already been taxed, IRS treats part of each benefit as a tax-free return of principal until the total benefit payments equal the taxpayer's cost. From that point on, the annuity payments are fully taxable. The abrupt shift in tax treatment may come as an unpleasant surprise to the elderly people who are affected.

Depending on the state where you live after retirement, you may pay little or no state income tax on retirement income. For retirees with substantial income, the state of residence can make a big difference.

b. How do IRS rules treat "early distributions" before age 59 ½?

Benefits paid from a qualified plan or IRA to an individual who has not reached age 59 ½, except certain early distributions permitted by IRS rules, are subject to a 10% excise tax (in addition to income tax).

Lump-sum distributions generally are subject to this "early distributions" excise tax, but a series of substantially equal periodic payments is not, such as a life annuity that can begin at any age. This is one reason to consider receiving benefit payments that commence before age 59 ½ as a life annuity.

c. How do IRS rules treat annual "minimum required distributions" after age 70 ½?

Benefit payments from an IRA (except a Roth IRA) must commence when the individual reaches age 70 ½. Benefit payments from a qualified pension or 401(k) plan must commence when the individual reaches age 70 ½ and is no longer working for the employer that sponsors the plan.

The individual must take at least the minimum required amount out of the IRA or other fund each year. Whatever amount is withdrawn gets taxed as income, even if the individual just moves the money to

another investment outside the IRA instead of spending it. Each year is treated separately, so an individual who takes out more than the minimum in one year may not count the excess toward the minimum for a later year. But each IRA is not treated separately -- someone with several IRAs may add them up and take the total minimum required payment from one account.

In January 2001, IRS revised its rules for computing minimum required distributions after age 70 ½. The changes are helpful for individuals, reducing both their paperwork and their taxes. Instead of making each person choose among several complex calculation methods at age 70 ½, IRS automatically applies one method that produces the lowest minimum distribution in all cases. Also, a taxpayer can easily change the payout arrangements after payments have begun or the owner of the account has died. These rules are not yet final but they can be used right away.

The bad news is that IRS continues to charge a very stiff 50% excise tax on any shortfall in actual payments compared to the minimum payments required in a calendar year. After age 70 ½ the financial institution or employer plan holding the funds usually will now notify both IRS and the individual each year about the amounts of required minimum distribution and actual distribution. IRS expects the changes will make it much easier to enforce their rules and collect the 50% excise tax. Clearly, people beyond age 70 ½ who have funds in IRAs or other pension accounts must be very careful to take the minimum required distribution each year.

Amounts paid under a single-life or joint-life immediate annuity usually will satisfy these IRS rules in a simple way that does not expose the annuitant to the 50% excise tax.

Appendix A - Information Sources

Many of the sources listed below can best be accessed on the Internet. Although the information often is very helpful, it is subject to change and we cannot be responsible for its completeness or accuracy.

Internal Revenue Service rules and tables: These IRS publications explain the tax treatment of qualified pension plans, IRAs, and other sources of retirement income. To get IRS publications or forms, telephone 1-800-829-3676 during business hours or go to irs.gov on the Internet.

Publication 571----- Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations

Publication 575----- Pension and Annuity Income

Publication 590----- Individual Retirement Arrangements

Publication 915----- Social Security and Equivalent Railroad Retirement Benefits

Publication 939----- General Rule for Pensions and Annuities

Retirement planning information and calculation tools: Nonprofit organizations with such information include American Savings Education Council (asec.org), AARP (aarp.org), and Employee Benefit Research Institute (ebri.org). Leading mutual fund firms and life insurance companies also make available useful educational material in print and on the Internet.

Rating agencies: The following private firms rate the financial strength of life insurers:

- A. M. Best Company (ambest.com)
- Duff & Phelps Credit Rating Co. (dcrco.com)
- Moody's Investors Service (moodys.com)
- Standard & Poors Insurance Ratings Services (standardpoor.com)
- Weiss Ratings Inc. (weissratings.com)

Annuity rates and planning information: These Web sites, operated by organizations who sell annuities, have information on post-retirement planning, rates that insurers charge for immediate annuities, dollar limits of state guaranty funds, IRS rules for withdrawing funds from qualified plans or IRAs, and discussions of charitable gift annuities:

- Annuityshopper.com
- Annuitynet.com
- Annuity.com

SEC warning to consumers about costs of some variable annuities: =The bulletin "Variable Annuities: What You Should Know" is available at the Web site of the Securities & Exchange Commission (sec.gov/consumer/varannty).

Appendix B – Example of Progressive Need for Personal Help

Many older persons develop chronic illnesses, and over a period of time progressively need more help. Here is an example for Joan showing her progress from age 70 until age 84 when she dies.

| Joan's age | Joan's situation | Help needed and cost in 1999 dollars |
|-------------------|--|---|
| 70 | Joan and her husband, Robert, age 75, are both retired. They are active, walk almost every day, but are phasing down activity level. Robert has heart disease, controlled by medication. They live in their own home with a yard in a suburb of a major northern city. | |
| 73 | Joan and Robert find it difficult to care for the house and yard and feel trapped in the winter. It's hard to get help with snow removal and they don't like to drive in snow. They're exploring other options for living. They've slowed down activities further. Joan is in good health but very concerned about meeting the demands placed on her. | |
| 75 | Robert dies. Joan relocates to an independent-living apartment complex. She has dinner provided, has access to activities, transportation, etc. Her apartment is cleaned weekly. | Cost of apartment and services is about \$2,500 per month |
| 76 | Joan is diagnosed with Parkinson's disease. With medication, she can handle most of her needs. She needs 5 separate medications taken in different combinations 4 times a day for a combination of Parkinson's and high blood pressure. Joan stops driving. | Same |
| 77 | Joan needs help paying her bills and managing her finances, plus help with shopping and errands. A family member is helping her about twice a week for a minimum of 6 hours per week with bill paying, errands and doctor's appointments. She can answer the phone and make calls only to pre-programmed numbers. She is still able to take a short walk on her own. | Same |
| 78 | Joan no longer can manage her own medication, and can't use the answering machine. A paid helper comes in for about 3 hours a day in addition to twice-a-week help from family members. | \$2,500 per month for the apartment plus \$1,200 per month for the assistant who comes in |
| 80 | Joan can no longer manage without help in bathing, dressing, and administering medication. She moves to an assisted living facility. A family member helps her 2 to 3 times a week. | \$4,000 per month including all meals, administering medication, assistance in bathing and dressing |
| 82 | Joan has extreme difficulty walking and trouble feeding herself. She has a great deal of difficulty speaking or hearing and often gets confused. She moves to a nursing home. She continues to get help from a family member 3 times a week. | \$6,000 per month for the nursing home |
| 84 | Joan dies. | |

Q. What lessons can we learn from this story?

A. Several aspects of aging come into sharp focus:

- Loss of function can occur gradually and chronic illness may last a very long time.
- Without an available family member, more help would be needed in this situation.
- Help can be integrated with housing. New solutions may be needed as the situation changes, and are likely to be progressively more expensive.

Q. Would long-term care insurance have helped?

A. Benefits would depend on the long-term care policy, as provisions vary widely. It is unlikely that benefits would have been payable before age 80, but they would probably have become available at that point, depending on how the policy treated care outside of a nursing home. Note that until Joan entered the nursing home, she would be considered to be in the community receiving home care.

Q. If there were no resources for support, where would Medicaid fit in?

A. Somewhere between age 80 and 82, if there were no other resources, Joan would probably have qualified for Medicaid payment for stay in a nursing home. Assets would have to be essentially gone in order to qualify and rules vary by state.

Appendix C — Definitions

401(k) plan — A type of retirement savings plan used by private firms or non-profit employers. Also known as a cash-or-deferred arrangement.

403(b) plan — A type of retirement savings plan used by some non-profit or governmental employers. Also known as a tax-deferred annuity.

457 plan — A type of retirement savings plan used by some non-profit or governmental employers. Also known as an eligible deferred compensation plan.

Activities of Daily Living (ADLs) — Activities of Daily Living are terms used in long-term care insurance policies or programs to specify someone's ability to function independently. ADLs usually include eating, dressing, bathing, transferring in and out of bed, and using the toilet, though some definitions are more liberal than others. LTC insurance policies often base eligibility for benefits on inability to perform 2 or 3 ADLs.

after-tax — Describes funds on which an employee has already paid all income taxes, for example, amounts held outside a qualified plan or traditional IRA, or within a Roth IRA. Taxes on benefits derived from these funds, plus investment earnings in a Roth IRA, are not payable when they are received. See basis. Also known as post-tax.

annuitant — The named individual who is entitled to receive annuity payments for life under a life annuity.

annuity — (1) A series of periodic payments. (2) A contract under which an insurance company promises to make a series of regular payments to a named individual for life.

annuity certain — An annuity that is payable for a stated period of time, regardless of whether an individual lives or dies.

annuity form or option — A choice of payment methods available to an individual getting a pension or annuity.

annuity rate — The single-sum price that an insurance company or pension plan charges for an annuity contract or option of a standard amount such as \$1 per month. Annuity rates usually vary by age, and by sex if the annuity is outside a private pension plan, and are in addition to fixed expense charges. Also known as annuity purchase rate. See unisex annuity rate.

basis — The aggregate amount contributed by an individual from after-tax funds toward the cost of an annuity or pension, which the individual later receives as tax-free benefits under IRS formulas. See after-tax.

before-tax — Describes funds on which the employee has not yet paid income taxes, for example, amounts held in a qualified plan or traditional IRA. Taxes have been deferred, not waived, and are normally due when funds are paid out from the qualified plan or IRA. Also known as pre-tax.

cash refund annuity — A type of refund annuity under which the refund is paid in a lump sum. See refund annuity and installment refund annuity.

cost-of-living adjustment (COLA) — An increase in a pension or annuity benefit to compensate for an increase in the cost of living.

deferred annuity — An annuity under which benefit payments do not begin when the annuity is purchased. In a typical deferred annuity, the individual accumulates money on a tax-deferred basis until retirement, then converts the accumulated value into income payments or withdraws it in a lump sum.

defined benefit plan — An employer pension plan with benefits based on formulas that recognize the individual's years of service and other factors such as pay.

defined contribution plan — An employer pension plan with benefits that equal the amounts contributed to employees' individual accounts plus actual investment earnings, plus forfeitures in some cases.

early distribution — Payment of benefits from a qualified plan or IRA to an individual who has not reached age 59 ½, except as permitted by IRS rules, resulting in an excise tax.

ERISA — The Employee Retirement Income Security Act of 1974, as amended. This federal law provides for regulation of private pension and employee benefit plans by the Department of Labor and Pension Benefit Guaranty Corporation. The IRS also regulates such plans under provisions of the Internal Revenue Code.

fixed annuity — An annuity under which the insurer guarantees to pay at least a specified monthly benefit amount for each dollar applied to purchase the annuity. Also called fixed benefit annuity.

forfeiture — The non-vested part of a participant's account balance in a defined contribution plan which he or she loses upon termination of employment before attaining full vesting. Under IRS rules, some defined contribution plans credit forfeitures to the accounts of all other participants.

guaranty association — An organization that protects persons from losses suffered through the insolvency of an insurance company.

immediate annuity — An annuity under which income payments begin when the annuity is purchased.

impairment — Any aspect of the health, occupation, activities, or life-style of an individual that could increase his or her expected mortality or morbidity.

income replacement ratio — The percentage of pre-retirement income that a retiree would need to receive after retirement in order to have a post-retirement standard of living equivalent to his or her pre-retirement standard of living. This ratio is generally less than 100 percent because some expenses (i.e., taxes, commuting costs, clothing expenditures, savings needs) decrease after retirement. Also known as a replacement ratio or rate.

indexing — Automatic adjustment of benefits to compensate for the effects of inflation after payments begin, generally in accordance with increases in the level of a price index such as the Consumer Price Index (CPI).

individual retirement account (IRA) — A personal retirement savings account that allows funds to accumulate without current income taxation on the investment earnings. Contributions to a traditional IRA up to \$2,000 annually may be tax-deductible, depending on the worker's earnings and coverage by a private pension plan. All distributions from a deductible IRA are taxable when received. See also rollover IRA, Roth IRA.

inflation-indexed Treasury bond — A U.S. government security that increases the payments of interest and principal in proportion to the Consumer Price Index (CPI).

installment refund annuity — A type of refund annuity under which the refund is payable in a series of periodic payments. See refund annuity and cash refund annuity.

joint annuitant — The annuitant's spouse or other individual named to receive survivor annuity payments after the death of the annuitant.

joint and survivor annuity — An annuity that provides a series of payments to two or more individuals as long as one of them survives.

life annuity — A series of payments that are made at regular intervals as long as a named individual, the annuitant, is then alive. Also known as a straight life annuity.

life annuity with period certain — A life annuity which promises that if the annuitant dies before the end of a designated period (usually 5, 10, or 20 years), the insurer will continue payments until the end of the designated period. Also called a life income with period certain annuity.

life expectancy — The average remaining years of lifetime for a group of people based on a specified mortality table or experience study.

life income with refund annuity — An annuity that pays benefits throughout the annuitant's lifetime and guarantees that total benefit payments will at least equal the purchase price of the annuity.

long-term care (LTC) insurance — Coverage available on an individual or group basis to provide medical and other services to patients who need constant care in their own home or in a nursing home.

lump-sum distribution — A single-sum payment to a participant retiring or terminating employment in a pension or employee benefit plan.

Medicaid — A joint federal-state health insurance program that is run by the states, with eligibility limited to low-income or disabled people.

Medicare — A federally sponsored health insurance program of hospital insurance (Part A) and supplementary medical insurance (Part B), primarily for individuals aged 65 and older.

Medicare supplement (Medigap) insurance — Medical expense coverage that pays for certain expenses not covered under Medicare.

mortality charge — The cost of the insurance protection element of a variable annuity contract.

nonqualified annuity — A type of annuity funded with money that has already been taxed by the U.S. government in the year in which the funds are deposited.

Pension Benefit Guaranty Corporation (PBGC) — The U.S. government agency that insures benefits in defined benefit pension plans.

pension plan — See defined benefit plan, defined contribution plan.

period certain — The stated period over which the insurer will make benefit payments under an annuity certain.

portfolio — A diversified pool of investments typically comprising stocks, bonds, or money-market instruments.

post-tax — See after-tax.

pre-tax — See before-tax.

qualified joint and survivor annuity — A form of annuity which provides for pension benefits from a qualified plan to continue to the spouse after a retired participant's death. The spouse's benefits are payable for life unless the participant (with consent of the spouse) has elected to forego it, and must be between 50 and 100 percent of the original benefits.

qualified plan — A pension plan or employee-benefit plan which meets a series of IRS requirements and is therefore eligible for income tax deferral.

qualified savings plan — A defined contribution plan with certain tax advantages offered by an employer or other plan sponsor to let employees invest for retirement or other needs. Many savings plans feature employer matching of employee contributions, with plan participation voluntary. Also known as a thrift plan, 401(k) plan, 403(b) plan, 457 plan, cash-or-deferred arrangement, tax-deferred annuity plan, or tax-sheltered annuity plan.

refund annuity — A life annuity that specifies that benefit payments will at least equal the purchase price of the annuity. See also cash refund annuity and installment refund annuity.

required minimum distribution — An amount that must be paid annually from a qualified plan or IRA to an individual who has reached age 70 ½ to comply with IRS rules.

reverse mortgage — A contract with a financial institution that allows a homeowner to get retirement income by borrowing against the equity in the home, with no repayment needed while the individual lives in the home.

rollover — The tax-free transfer of an account balance between an individual retirement account and a qualified retirement plan or another individual retirement account.

rollover IRA — A type of individual retirement account usually funded with money transferred from a former employee's company-sponsored retirement plan account. Investment earnings continue to grow tax-deferred until benefits are distributed.

Social Security — A U.S. government program that provides retirement, survivors, and disability income benefits for eligible workers and their families. Formally known as Federal Old-Age and Survivors Insurance and Disability Insurance or OASDI.

unisex annuity rate — An annuity rate that is the same for men and women, as required by federal law governing benefits under public and private employee benefit plans, even though women tend to live longer than men and thus pay more than men for an annuity issued outside such a plan.

variable annuity — An annuity under which monthly payments vary depending upon the value of the underlying investments, such as common stocks.

Appendix D – Suggested Range of Systematic Withdrawals

The following table published by a large mutual fund investment firm gives general guidelines as to the maximum percentage of your assets you can afford to withdraw each year to reduce the risk of outliving your assets while maintaining your standard of living:

| Age | Percent of Assets |
|------------|--------------------------|
| 50s | 3 - 5% |
| 60s | 4 - 6% |
| 70s | 5 - 7% |
| 80s | 6 - 8% |
| 90s | 8 - 10% |

These guidelines assume an average annual investment return about 3% higher than the average rate of inflation. The figures are only rough guides because nobody can predict how long you'll live, how well your investments will do, or how much inflation you'll experience. To reduce your risk of outliving your assets, especially if you are a woman, avoid consistently withdrawing the percentage at the high end of the guideline range and reassess your situation at least every 3 years.

It's interesting to compare these figures with others from American Savings Education Council (ASEC):

| Expected retirement age | Amount you should accumulate, per \$1 of annual income you'll need * | Estimated percent of assets you can receive annually ** |
|--------------------------------|---|--|
| 55 | \$21.00 | 4.8% |
| 60 | \$18.90 | 5.3% |
| 65 | \$16.40 | 6.1% |
| 70 | \$13.60 | 7.8% |

* These figures assume 3% inflation and are published by ASEC on the Internet at asec.org/ballpark.

** Computed by dividing the amount in the prior column into \$1.00.

The percentages in the last column, based on the ASEC data, recognize that a retiree could buy an annuity that transfers to an insurance company the risks of longevity and investment return. The lower percentages suggested in the prior table are appropriately a bit more conservative as they are intended for systematic withdrawals where the individual retiree bears those risks.