How *Not* to Outlive Your Money

By John Hauserman, CFP®

Ever worry about outliving your money? If so, please read on.

During the summer and fall of 2014, federal tax authorities issued several clarifications to their official guidance surrounding the use of longevity insurance. In short order, several major insurance companies have jumped on board with offerings designed to meet the somewhat stringent criteria set forth. However, before jumping into the details, first let's review exactly what longevity insurance is.

To be clear, longevity contracts existed prior to the summer of 2014. However, their use was limited to non-IRA assets, owing to the fact that tax legislation had previously required forced withdrawals from IRAs, an act forbidden in longevity contracts. Technically speaking, longevity insurance is no more than an immediate lifetime annuity with a significantly delayed starting date — often after the age of 80. As a lifetime annuity, guaranteed level payments (usually monthly) are made by an insurance company for the remaining life of the annuitant (you). **So, why would a person want to invest their money into a contract that won't give them any benefits until they are very old?** The answer is fairly simple: to help manage the risk of outliving your savings and investments.

Perhaps the best way to illustrate this concept is through a real-world example. Let's assume that a 65-year-old man is getting ready to retire. He has $400,000 in savings and investments and is worried that if he lives well into his eighties, or even nineties, he may run out of *money* before *years*. If he were to purchase longevity insurance for $50,000 and design his policy to begin payments when he is 85, his monthly check might be around $1,200* ($14,400 annually). Some quick math might suggest that in a little under three and a half years he would break even on his investment. In six years he would have received $86,400 and in 10 years he would have nearly tripled his original premium with just over $144,000 in income payments. But is this a good deal and what are the risks to the investor? After all, while the latter sum represents a significant increase from the original investment, it did take 35 years to collect the money!

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Payout is interest-rate sensitive and is based on rates at time of initial contract creation. Periods of higher interest rates may result in a higher payout to the investor. Conversely, periods of lower interest rates would result in a lower payout. The above quotes were valid as of January 2015. All payments and benefits are subject to the claims-paying ability of the insurer. This is a hypothetical example and is for illustrative purposes only. No specific investments were used in this example. Actual results will vary. Past performance does not guarantee future results.

Whether or not this is a good deal can only be answered well into his future. Obviously, should he live to the ripe old age of 100 he would make out far better than if he collects just a few payments and then dies. Since this outcome can neither be known nor predicted, the better question might be: Is this *ever* an appropriate strategy to have as part of a well-thought-out plan?

Let's begin by focusing on some of the reasons why you might *not* want to invest in such a contract. The first reason centers on the reality that these contracts are designed to be very inflexible. This is done in part because the IRS says so, but also to maximize the benefits for contract holders. The term for this type of policy is a *qualified longevity annuity contract* (QLAC). In this case the term *qualified* refers to IRS interpretation; the reasoning and benefits of which we will discuss in the next paragraph. In order to receive favorable tax status, certain minimum criteria must be met including:

1. must have no cash value
2. must be irrevocable
3. must pay out immediately on death
4. can't be variable or indexed for accumulation

As a result, before investing you must be ***very*** sure that this contract makes sense for your situation since it is difficult or impossible to change course once implemented. What this means in simple terms: Once invested you (or your estate) can only get your money back through death (maybe) or living beyond the target age. **Passing away before the target start date, or shortly thereafter, represents the single largest risk to this strategy**. The caveat to the above is that your estate *can* get your premium back if you die before the payout start date, provided you chose the refund option (must be chosen at contract creation). Please note, however, that choosing the refund option will significantly reduce the potential monthly benefit amount. For example, the illustration referenced above in which the investor gets $1,200 per month would be reduced to $1,090 if the refund option was chosen. In the case of a surviving spouse, the payments may continue but will also result in a lower benefit amount.

So now that we have covered many of the reasons why it may not make sense to invest in a QLAC, let's consider why it sometimes could be wise. As mentioned, the IRS has weighed in on the subject. Specifically, the Feds have ruled that when a QLAC is used as part of an IRA or 401k, the usual required minimum distributions (RMD) at age 70.5 are stayed. In other words, you do not have to take money out and pay the associated taxes. Now, to be certain, the avoidance of RMDs should not be considered as sole justification for using a QLAC. After all, the reason *why* the contracts are *RMD-free* is because you have given up access to your own money. Also, keep in mind that those wishing to stave off RMDs could inadvertently find themselves at a very old age paying taxes on both RMDs (from other accounts) and the QLAC payout. As a result, use of a QLAC in an effort to manage future tax burdens should never be considered without first executing a comprehensive financial plan with the help of a qualified adviser.

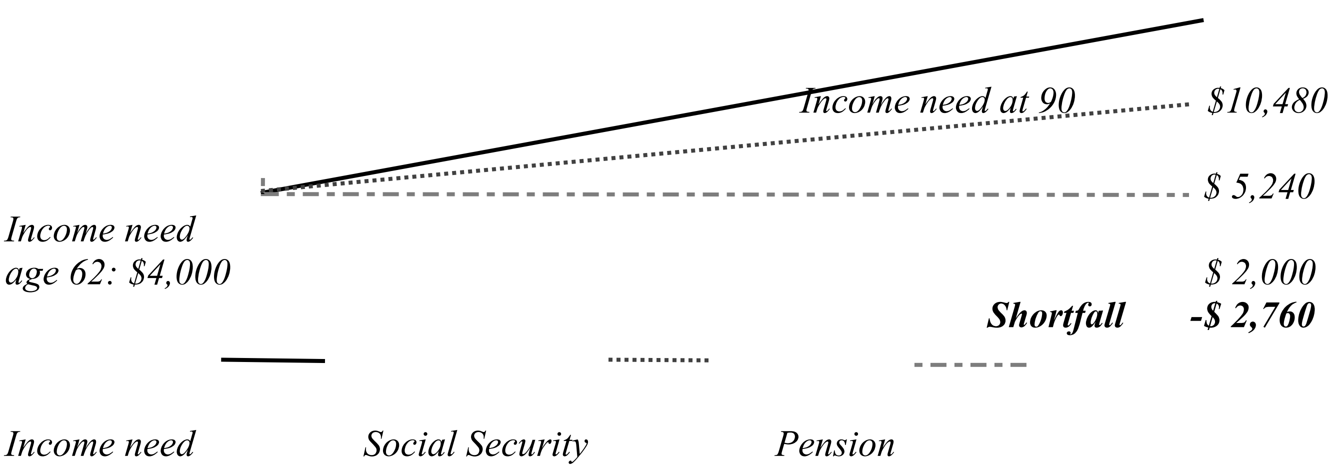
Naturally, when it comes to the IRS there are some rules to be followed. For example, you can put no more than (the lesser of) $125,000 (2014 indexed for inflation) or 25% of your retirement plan balances into a QLAC. Other rules have already been covered and are mainly designed to restrict access to your money for any purpose other than longevity risk abatement.

Another scenario in which a QLAC might make sense involves nursing home or long-term care insurance (LTC), or more specifically the lack thereof. While not a perfect fit for the situation, individuals who do not have LTC may be candidates. Whether you can't get coverage due to medical history, or feel that it is just not affordable, the lack of protection can prove a major risk factor when planning a retirement. At current writing, the average cost for a nursing home in our area can range between $75,000 and $200,000 a year. The specter of an extended stay can loom ominously over one's sense of financial well-being and may ultimately wreak havoc on your nest egg. While a QLAC does not provide traditional nursing care benefits, should an expensive stay wipe out savings, the promise of guaranteed future income could prove a true financial lifeline for the surviving spouse. Also, since the QLAC can't have a cash value, it may not have to be listed among cash assets when entering a nursing facility or qualifying for government benefits. The laws governing this scenario are likely to differ from state to state, so be sure to consult an attorney before using this strategy.

Yet another scenario, which may be one of the most compelling and in which a QLAC might make sense, involves those who derive much of their needed retirement income from a fixed pension that *does not* provide for adequate cost of living adjustments. While such pension arrangements might provide adequate income during the early years of retirement, that reality might not hold true during a 20 or 30 year stint. Imagine trying to live on the same income that you did two or three decades ago. Consider below:

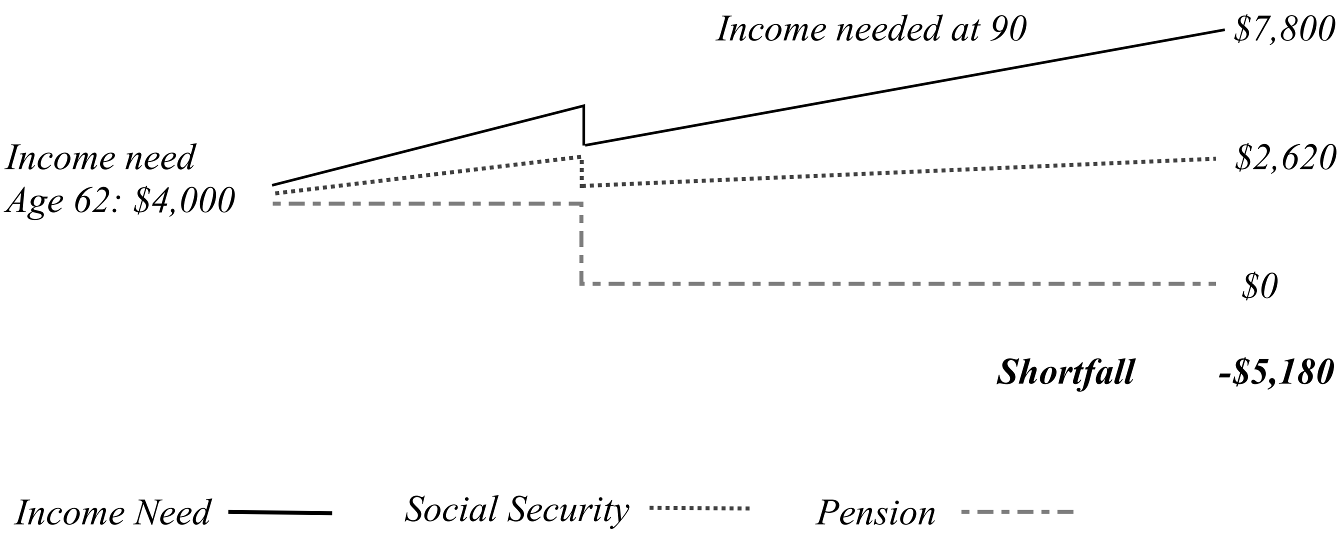
Figure 1:

Mr. and Mrs. Smith both retire together at age 62. They need $4,000 a month to live a comfortable retirement and are entitled to $2,000 a month in Social Security and also $2,000 a month from his company pension plan. While Social Security does include a cost of living adjustment, his pension does not. If they both live to age 90:



As we can see, inflation slowly erodes the Smith's buying power, leaving them with a shortfall of about 25% in their later years. While this scenario might be alarming, if we change a few assumptions it could prove financially tragic. (See Figure 2 on next page.)

Figure 2:
Keeping the prior assumptions the same, we change only the fact that Mr. Smith has chosen the life-only pension option in order to get the highest benefit amount and then he passes away at the age of 72. Additionally, while Mrs. Smith (as a survivor) can live on about 25% less than the two needed as a couple, she will get only one of the two Social Security checks ($1,000 each) that the couple had been receiving.



Under this set of assumptions, Mrs. Smith spends many years trying to make ends meet on a budget that ends up being about two-thirds short of her needed amount. Now, for sure, the presence of life insurance might have made a pretty big difference in this example. However, for those who may be medically unable to get the insurance or for whom the premiums are just too expensive, a QLAC may prove a very good fit. Please also note that in this situation, ***she*** *would be the annuitant (insured) and not him, since we are seeking to protect her interests.*

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At this point we have reviewed what longevity insurance actually is as well as some examples when it may or may not make sense as an investment or risk management strategy. Allow me to conclude with some thoughts on the subject.

In preparation for this white paper, I ran a number of hypothetical financial plans in which I made a wide set of assumptions regarding portfolio values, spending patterns, and life expectancies, as well as pension and Social Security income amounts. I have to admit that I was surprised to discover that in almost all of the scenarios that I ran (assuming that a couple lives to their natural life expectancy or even beyond *and* has meaningful savings or investments that are invested in a well-diversified portfolio), the use of a QLAC was not mathematically warranted. In other words, using a QLAC would have resulted in a lower chance that the couple could end their lives with a remaining nest egg. **Now, it is imperative to be aware of the fact that while the scenario is likely to cause a depleted portfolio at an earlier point in life, it did simultaneously provide meaningful *income* during those later years.** To be fair, it should be noted that the quotes used for the QLAC were generated during a period of historically low interest rates (10 year treasury at 1.82%). Scenarios run during periods of high interest rates would almost certainly suggest very different conclusions. Also, when we assumed an unexpectedly short life expectancy for a pensioner the results varied greatly. My thoughts are as follows:

Those who *might* want to consider using a QLAC

1. A spouse who has chosen the life-only pension payout and carries insufficient permanent (not term) life insurance.
2. Those who have no long-term care insurance.
3. Investors who, due to very low risk tolerance, invest only in low yielding assets like CDs, money markets, or savings accounts.
4. Those whose financial plan indicates that they will likely run out of money no matter what they do.
5. Those whose financial plan indicates that they are so well funded through investments that they can afford to set aside money for a QLAC and who choose to do so to cover unforeseeable events.

Those who are *unlikely* to benefit from using a QLAC

1. Those whose financial plan indicates that they are so well funded they need not worry about running out of money (similar to #5 above, just a different mindset).
2. Investors who are aware and comfortable with the risk and return characteristics associated with a well-diversified portfolio.
3. Individuals with short life expectancies.
4. Retirees whose pension income is sufficient, provides cost of living adjustments and has a joint life payout option of 75% or higher to protect the non-covered spouse.

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In order to best asses the above data, I can't stress the importance of making such decisions only after the completion of a comprehensive financial plan, ideally created with the help of an objective expert. What you want to avoid is a *so-called* adviser who has an agenda of either persuading or dissuading you from investing in a QLAC.

Contact John Hauserman at RetirementQuest Wealth Management for a complimentary consultation. 410-442-4431 or visit www.RetirementQuestWealthManagement.com.
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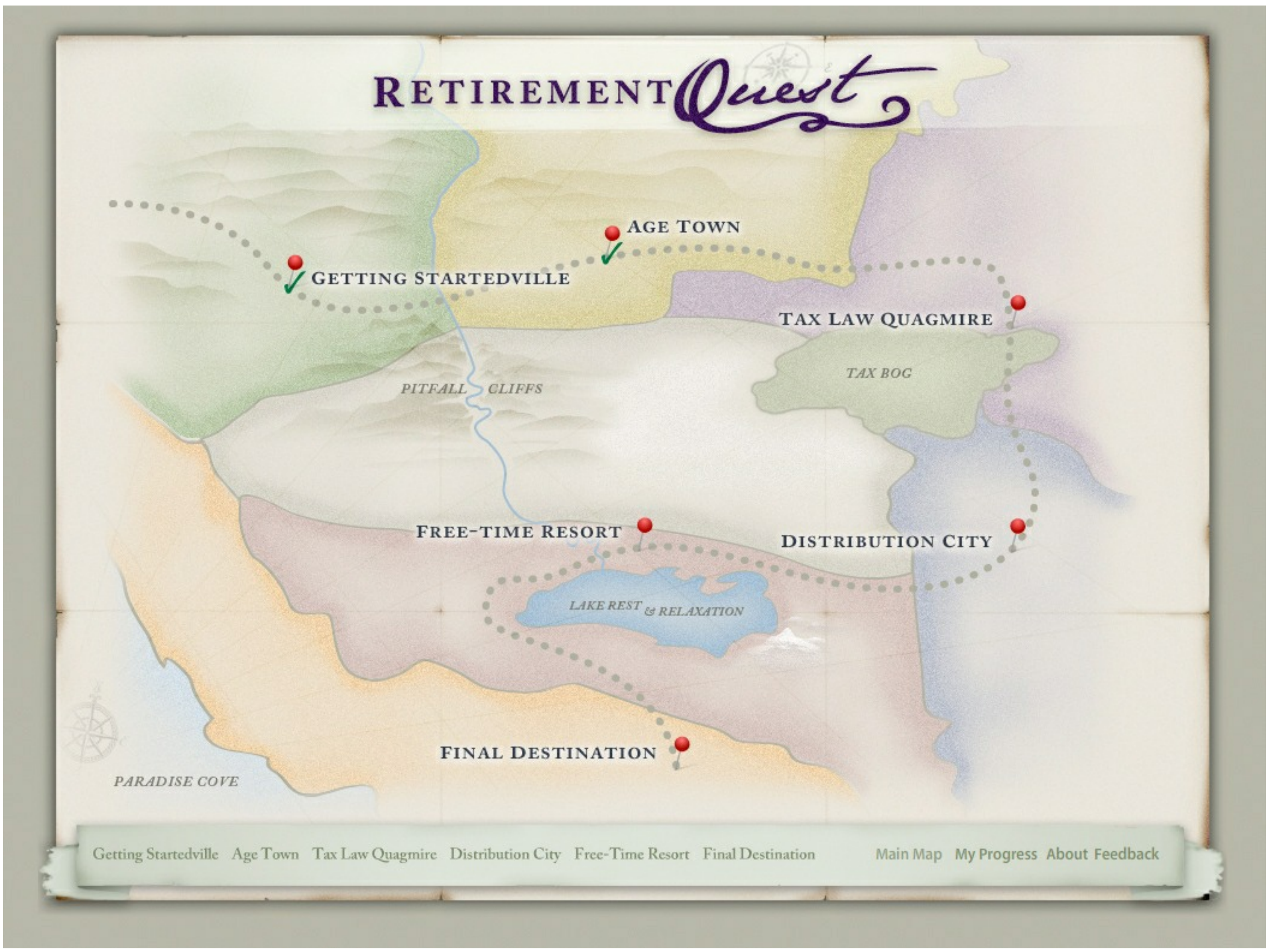

Check out the RetirementQuest interactive planning map! Created by John Hauserman, CFP®, this tool is designed to help you learn about the financial planning process in a way that most people find easy to understand.

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