8 reasons fixed-income annuities belong in your IRA

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Published: May 12, 2014 5:00 a.m. ET

In addition to understanding the details of a potential investment and how it will meet your needs, there are occasions when you need to decide where it will be held.

Will your investment reside in a nonretirement or retirement account? There are different income-tax consequences that can affect the longevity of a particular investment as well as your overall portfolio depending upon where it's held.

While there are income tax deductions available for making contributions to retirement, or "qualified," accounts, these types of accounts are generally not as tax-friendly as nonretirement accounts when taking withdrawals from them. The potential unfavorable income-tax consequences include (a) full taxation of withdrawals with potential exclusion for nondeductible contributions and Roth IRA distributions and (b) compliance with IRS' required minimum distribution, or RMD, rules.

Having said this, if you own a traditional IRA, there's an investment that's often overlooked that can be a natural fit in the right circumstances. It's called a fixed-income annuity.

What is a fixed-income annuity?

A fixed-income annuity is a fixed (as opposed to variable) annuity that provides either a lifetime payout or payments over a contractually-defined term. The payments are a fixed amount unless an inflation factor is added.

There are two basic types of fixed income annuities that are distinguished by the timing of their initial payments: immediate and deferred.

Immediate annuities are purchased with a lump sum, or single premium, and thus are referred to as single premium immediate annuities, or "SPIA's." Payments begin one month after the purchase date when a monthly payout option is elected, with quarterly and annual payouts available.

The start date for deferred fixed-income annuity payments is at least one year after the date of purchase and is typically much longer. Single premium deferred annuities ("SPDA's") are purchased with a lump sum while flexible premium-deferred annuities (FPDAs) allow multiple purchases.

Two types of deferred fixed-income annuities

There are two types of commercially-available deferred fixed-income annuities: (a) deferred-income annuity, or DIA, and (b) fixed-index annuity, or FIA, with an income rider. Both offer sustainable lifetime income, the payment amount of which is either known or can be calculated at the time of investment, depending upon the type of fixed-income annuity, with taxation deferred until payments are received.

There are four basic differences between a DIA and a FIA with an income rider:

- The income start date is contractually defined with a DIA and is flexible with an FIA, with the exception of the earliest start date, which is contractually defined and is typically age 50 and one year of ownership.
- In addition to deferred income, there's an investment, or "accumulation," value with a FIA versus none with a DIA.
- FIAs have a death benefit equal to the contract's accumulation value whereas this is generally optional with a DIA, and, when elected, is payable as a return of premium only in the event of death before the income start date.
- Distributions from DIA's held in non-retirement accounts are tax-favored since a portion of each payment is nontaxable as a return of principal until 100% of one's original investment has been returned, while "last-in first-out," or LIFO, tax treatment applies to FIA income withdrawals with 100% of distributions taxable as ordinary income until all earnings have been received.

See: FIA's With Income Riders vs. DIA's: Which is Right for You?

Why can fixed income annuities work well in a traditional IRA?

When analyzing potential investments for inclusion in a traditional IRA, SPIA's, DIA's, and FIA's with income riders are all potentially suitable depending upon the individual IRA owner's financial situation, including tax bracket.

There are eight reasons why one or more fixed-income annuities can make sense for a portion of one's traditional IRA accounts:

1. Comply with required minimum distribution rules

The IRS requires you to take minimum distributions, RMDs, each year from your traditional IRA accounts beginning by April 1 of the year following the year that you turn 70-1/2. The amount of your annual distribution is calculated using the value of your traditional IRA accounts, excluding fixed-income annuities, as of Dec. 31 of the prior year and a life expectancy factor from an IRS table.

See: RMD: A sensible systematic withdrawal plan

The purpose of the life expectancy factor is to liquidate the IRA owner's account through annual distributions over the joint life expectancy of the IRA owner and his/her beneficiary. Fixed-income annuities generally comply with the IRS' RMD regulations provided that payments (a) are structured so that they will be completely distributed over the life expectancy of the owner and the owner's beneficiary, and (b) begin by April 1 of the year following the year that the owner turns 70-1/2.

2. Don't need to sell investments at inopportune times to comply with RMD rules

With all three types of fixed-income annuities, you either know, or can calculate, the amount of your periodic payments beginning at a certain date at the time of purchase. Subject to the claims-paying ability of individual life insurance companies, you will automatically receive your payment – whether it's monthly, quarterly, or annually -- for the rest of your life.

In addition to not having to worry about recalculating your required minimum distributions and making sure that you take them by Dec. 31 each year, there are no investment sale timing considerations with fixed-income annuities. With other types of investments, securities must be sold to process RMD's unless sufficient cash is readily available in your IRA account. The securities sales may need to occur in unfavorable stock markets.

3. Provide a sustainable lifetime income stream

Fixed-income annuities provide you, and your spouse, if married, with a sustainable, lifetime income stream or pension. This is a desirable retirement income planning design feature since.it allows you to sleep better at night knowing that you will receive uninterrupted income that will cover a portion of your fixed, and perhaps, discretionary, expenses for the rest of your life.

4. Enable income targeting at time of purchase

Investment in deferred fixed-income annuities such as DIAs and FIAs with income riders also provides you the opportunity to target a desired amount of income beginning at a specified date as late as April 1 of the year following the year that you turn 70-1/2 at the time of purchase. The amount of your IRA that's allocated to fixed income annuities can be backed into using the targeted amount of sustainable lifetime income that you want to create to supplement Social Security and other potential income streams to cover your various projected retirement expenses.

5. Simplify your financial life

When you get to a certain point in life, there's a tendency to want to downsize and simplify, including your investments.

Transfer of funds from a traditional diversified investment portfolio into one or more fixed-income annuities through one or more life insurance companies can accomplish this goal in an IRA account in four ways:

- Reduced risk
- Known lifetime income stream beginning at a specified age
- Elimination of investment management on funds transferred
- Reduction or elimination of investment management fees

According to MarketWatch columnist Howard Gold, "physiological changes in the aging brain can cause significant declines in our ability to process new information, handle risk or react appropriately to market events." It's the biggest retirement risk no one talks about. Given this situation, it behooves us to recognize this issue and take proactive steps well in advance of retirement to simplify our financial life.

6.Reduce income taxation objections associated with nonqualified annuities

Higher income individuals who are often reluctant to invest in fixed-income annuities in non-retirement, or "nonqualified," accounts due to potential unfavorable income-tax consequences are sometimes more inclined to implement this strategy within their traditional IRA accounts. This is due to the fact that all income from traditional IRA accounts is taxed the same, irrespective of its source. 100% of the distributions, with a potential exclusion for nondeductible contributions, are taxed as ordinary income.

Fixed-index annuities with income riders can be a good fit for a traditional IRA since taxation is identical to holding them in a nonretirement account until all earnings have been received. SPIAs and DIAs are often better suited tax wise when held in nonretirement accounts. This is due to the fact that a portion of each payment from SPIA's and DIA's is excluded from taxation as a return of principal until 100% of one's original investment has been recovered. The taxable portion of all nonqualified annuity payments, however, is considered to be investment income subject to the net investment income tax of 3.8%.

7. Reduce exposure to stock market declines

Not to be overlooked is the fact that transfers from equity investments such as stocks, mutual funds, and exchange-traded funds into fixed-income annuities before a stock market downturn can be used as a strategy to mitigate the decline in value of your IRA and potential associated ability to retire at a desired date or to remain retired.

Investments in all three types of fixed-income annuities are immune from stock market declines.

8. Eliminate state premium tax

Six states assess a premium tax on annuity owners that's deducted from annuity payouts by five states, with one state, South Dakota, deducting the tax at the time of purchase. The tax ranges from 0.5% to 3.5% and is applied based on the state in which the purchaser resides when the premium is paid.

Four of the six states — Maine, Nevada, South Dakota, and Wyoming — assess the tax on nonqualified funds only. California's tax rate is 0.5% on qualified funds and 2.35% on nonqualified funds. West Virginia charges a 1% tax on qualified and nonqualified funds.

Given the fact that four of the six states assess a premium tax on nonqualified funds only and a fifth state assesses a higher tax on nonqualified funds, it's preferable to hold fixed-income annuities in qualified accounts, including traditional IRA's, all else being equal when given the choice if you purchase your annuity in one of the five states that are tax-friendly toward qualified annuities.

Due diligence and thorough analysis a must

While fixed-income annuities can be a natural fit for a portion of one's traditional IRA accounts in the right situation, specialized expertise is required to plan and implement a fixed-income annuity strategy as part of a retirement income plan. As is the case with all investments, due diligence and thorough analysis needs to be performed before making any purchases.

Financial stability of proposed life insurance carriers and investment carrying costs, including surrender charges and income rider fees in the case of fixed-index annuities with income riders, are some of the things that need to be considered due to the required long-term commitment.