Individual Retirement Annuity- The Solution To The SPIA RMD Dilemma

When most people hear the term “IRA” they think Individual Retirement ARRANGEMENT, that mainstay of defined contribution retirement planning. You may have a traditional IRA, you use its cousin the Roth IRA via the backdoor, and you can even rollover your 401K or 403B from work into an IRA after you separate from employment. However, today we’re going to talk about another IRA, the individual retirement ANNUITY.

“Annuity?!” you may say. I thought this was The White Coat Investor. Surely he’s not going to encourage us to use an annuity after all the bad stuff he has written in the past about not mixing investing and insurance. Relax Tex. Remember there is at least one “good” annuity, the single premium immediate annuity (SPIA), and that’s the type of annuity we’re talking about today.

What’s a SPIA?

There is a lot of talk in the investing and personal finance literature about using SPIAs in retirement. (If you weren’t aware there was an investing and personal finance literature its time you got up to speed on your Continuing Financial

Education – CFE.) A SPIA insures against your running out of money if you live a long time, longevity insurance if you will. (Although annuity salesmen like to use that term for a type of deferred annuity that is relatively cheap but doesn't pay anything until you're pretty old, like 85 or 90.)

How Does A SPIA Work?

With a SPIA, you pay an insurance company a lump sum, and then they send you a check every month for the rest of your life. The older and sicker you are when you buy the SPIA, the larger the check. Interest rates affect your SPIA rate a great deal when you are relatively young (like 50) but much less as you get to be 70 or older. At those ages, the mortality credits have much more to do with the annuity rate than interest rates. Despite today's historically low interest rates, a 70 year old male can buy a SPIA on himself that pays him 8.12% of the lump sum per year, over double the "4% SWR rate" frequently discussed. That isn't indexed to inflation. If you want the annuity to adjust with the CPI-U, the current rate for that 70 year old male is 5.9%.

Why Would I Want A SPIA?

Since pensions are going the way of the dodo bird, a SPIA allows you to buy a pension. Since the income is guaranteed, and you are guaranteed not to leave anything behind, you actually end up with a higher withdrawal rate from a SPIA than safe withdrawal rate (SWR) studies show you can have from your portfolio of stocks and bonds. So many people (like most doctors) who arrive at their retirement years with a large lump sum of money from their years of retirement savings but no pension decide to purchase a SPIA or two with part of their savings to provide a floor to their retirement income. The idea is that the SPIA and Social Security pay for your needs, and your portfolio of stocks and bonds can pay for your wants and any legacy you wish to leave behind to your heirs or charity. You can even ladder SPIAs by purchasing one at 65, one at 70, another at 75, and perhaps one more at 80 as an alternative to purchasing an inflation-indexed SPIA.

Taxable SPIAs

You can buy a SPIA with money from your taxable account. You sell your mutual funds, pay your taxes, and buy the annuity. Part of the annuity payment each year is return of principal and part is interest, which is taxed at your full marginal tax rate. To determine how much of that is taxable, divide the lump sum you bought the annuity with by your life expectancy. If you bought a $100K annuity and you're expected to live 20 years, then $5K per year is return of principal, and the rest ($3K or so) is taxable interest.

Individual Retirement Annuity

However, what if the money you wish to buy the annuity with is now inside a traditional or rollover IRA? What should you do then? There are three choices. The first is to pull the money out of the Individual Retirement ARRANGEMENT, pay your full marginal tax rate on it, then buy a SPIA just like in the above example. The second option is to buy the SPIA inside the Individual Retirement ARRANGEMENT. The problem with this approach is that you then have to do a complicated calculation each year to determine the value of the SPIA so you can calculate your required minimum distribution (RMD) for the year. The last option is to transfer the money from your Individual Retirement ARRANGEMENT into an Individual Retirement ANNUITY. Once you do that, the money is out of the Individual Retirement ARRANGEMENT, and so the RMDs from that account are calculated on the now smaller amount. The monthly payments from the Individual Retirement ANNUITY constitute the RMD. Since that money has never been taxed, the entire monthly payment is fully taxable, just like an RMD from a tax-deferred retirement account.

Example

Assume you're 70 and have a $1 Million traditional IRA. The IRS requires you to take out 3.6%, or $36,000 as your required minimum distribution. If you decide to buy a SPIA with $200K, your traditional IRA now has $800K in it, and your RMD is $28,800. Your SPIA pays 8.12%, or $16,240 which is all taxable. So if you spend your entire RMD, you have a fully taxable income of $45,040, or about 4.5% of the original amount.

Let's say you live to be 90 and thanks to reasonable returns, your IRA is still worth $500K after 20 years of withdrawals. Your RMD on that amount is $43,860, or 8.5% of the total. The SPIA is still paying out $16,240 per year. So your taxable income is now $60,100. Notice that the RMD on an Individual Retirement ANNUITY (the annuity payment) is larger than the "RMD" from an individual retirement ARRANGEMENT in the early years, then eventually becomes lower as you can see in this chart:

Age	RMD %	8% SPIA
70	3.6%	8%
71	3.8%	8%
72	3.9%	8%
73	4.0%	8%
74	4.2%	8%
75	4.4%	8%
76	4.5%	8%
77	4.7%	8%
78	4.9%	8%

79	5.1%	8%
80	5.3%	8%
81	5.6%	8%
82	5.8%	8%
83	6.1%	8%
84	6.5%	8%
85	6.8%	8%
86	7.1%	8%
87	7.5%	8%
88	7.9%	8%
89	8.3%	8%
90	8.8%	8%
91	9.3%	8%
92	9.8%	8%
93	10.4%	8%
94	11.0%	8%
95	11.6%	8%

That's not such a bad deal. You do pay more tax early on using a SPIA, but its mostly just because you're withdrawing and spending more from your retirement savings. But you should be aware that if your goal is to delay your tax as much as possible (rather than to actually spend as much as you safely can), you might not want to use an individual retirement ANNUITY and just deal with the hassle of having your SPIA inside your individual retirement ARRANGEMENT. But you're getting into a pretty gray area with the IRS since they've never issued guidelines about how to value a SPIA (using a present value calculation of the annuity cash flow) inside an individual retirement ARRANGEMENT. Then again, what's the point of buying a SPIA if you don't want to spend the income from the SPIA each year?

Remember of course that your spending rate and the RMD have nothing to do with each other. You can take out more than the RMD and spend it. You can also take the required RMD out of the IRA and invest it in a taxable account without spending any of it. All the IRS requires is that you take out the RMD. They don’t care how much you spend.

An individual retirement annuity is the ideal way to hold a SPIA purchased with tax-deferred money. You avoid the big upfront tax bill that would occur if you withdrew the money from the IRA prior to purchasing the SPIA, and you avoid having to do complex RMD calculations each year.