



REFORMING RETIREMENT INCOME Annuitization, Combination Strategies, and Required Minimum Distributions

American retirees face significant challenges when planning for lifetime retirement income. Specifically, they must devise financial plans that best balance the risk of outliving their assets with the need for flexibility and liquidity. Transferring a portion of retirement assets into life annuities, which pay a predetermined amount regularly for the life of the insured, has been shown to help retirees better achieve these goals. The Department of the Treasury has taken steps to incentivize particular types of partial annuitization, but broader changes to tax rules are needed to allow and encourage retirees to pursue the most efficient partial annuitization strategies.

A new study published by the Mercatus Center at George Mason University investigates more efficient partial annuitization strategies and the rule changes necessary to set these strategies on an equal tax basis with those favored by the Obama administration. The study uses historical simulations to demonstrate the efficiency of combining systematic withdrawals from a dynamically changing asset portfolio with the laddered purchase of immediate life annuities over an extended period of time. The study proposes steps regulators can take to make this genus of retirement strategy more attractive.

To read this study in its entirety and learn more about its author, Mercatus senior research fellow [Mark J. Warshawsky](#), see [“Reforming Retirement Income: Annuitization, Combination Strategies, and Required Minimum Distributions.”](#)

KEY FACTS

- *Retirees face significant challenges when planning their financial future.* Retirees who rely solely on a strategy of drawing down assets run the risk of outliving their savings. Life annuities mitigate this risk by offering guaranteed income for life. However, converting the entire retirement portfolio into life annuities immediately upon retirement fails to provide end-of-life assets for bequests, is a poor hedge against inflation, and also does not provide

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sufficient liquidity in the case of emergencies such as health needs and long-term care not covered by insurance. Therefore many financial planning experts favor partial annuitization strategies.

- *Current rules encourage inefficient partial annuitization strategies.* Specifically, recent tax rule changes incentivize “longevity insurance,” a type of life annuity that is deeply deferred (often to age 85). A careful reading of the professional literature, however, shows that longevity insurance is currently an inferior strategy, because longevity insurance policies tend to have significantly higher loads than immediate annuities.
- *A combination strategy of asset withdrawals and purchases of immediate life annuities provides the best balance of lifetime income and flexibility, but current tax rules do not favor such a strategy.* Historical simulations demonstrate the superiority of combining asset withdrawals and laddered purchases of immediate life annuities. This genus of partial annuitization strategy could be incentivized by making a broad and simple change in the tax regulations that nevertheless maintains the essential policy purpose of the regulations.

SUMMARY

- *Prior literature shows that annuities outperform the commonly used 4 percent asset withdrawal rule (the Bengen rule) in producing income for individuals retiring at common ages.* While annuities meet the primary retirement-planning goal of providing income, they fail to achieve other common objectives, such as leaving assets for bequest or providing liquidity for large late-life expenses.
- *Prior literature shows that combination strategies using both asset withdrawal and annuitization with corresponding changes in asset allocation have been shown to achieve more of these common objectives.* For example, annuitizing half of a historically simulated portfolio leaves a bequest that is just somewhat smaller than the one that would be left by an asset-only portfolio. Liquidity concerns are also addressed with the remaining portfolio, because assets can be liquidated if necessary, but the strategy still offers the valuable income security that comes with annuitization.
- *In new results presented in this paper, a combination strategy of laddered annuitization and asset withdrawal is found to be superior to a pure withdrawal strategy or a pure annuitization strategy.* A pure withdrawal strategy carries a risk that the retiree will outlive the assets. It also provides lower average income for most retirees. On the other hand, a pure annuitization strategy provides significantly lower income at the 30-year mark, owing to inflation. A laddered purchase of immediate life annuities combined with systematic withdrawal is superior to either of these strategies.
- *Earlier retirement and a long life make combination strategies even more attractive.* The study simulates a combination strategy (as described above) for an individual retiring at age 62 and living to age 102. At this 40-year mark the 4 percent withdrawal rule fails almost 35

percent of the time, while the combination strategy is estimated to produce strong income and leave a healthy balance at the time of death.

POLICY RECOMMENDATIONS

- *Required minimum distribution (RMD) rules state that after age 70.5, minimum distributions must be made from all types of qualified retirement plans and assets. These required distributions increase with age and must be included in taxable income.*
- *Current RMD rules penalize annuitization by not completely counting annuity payouts toward RMD requirements. Thus retirees with a partially annuitized portfolio will be required to pay taxes significantly earlier than retirees using a zero-annuity strategy.*
- *The Treasury has revised RMD rules to encourage one form of partial annuitization. The IRS has allowed longevity insurance, which is essentially a deeply deferred annuity, to count toward RMD requirements. However, this type of deferred life annuity has been shown to perform poorly compared to immediate life annuities.*
- *The Treasury should adjust RMD rules to treat all annuities the same as assets. This will incentivize laddered purchases of annuities at whatever rate is deemed optimal for individual retirees and will dramatically simplify an unnecessarily complicated portion of the tax code. Because this rule adjustment would be consistent with the relevant statutory requirements, it will only require a change in regulations and not a change in law.*

CONCLUSION

The best strategy to produce lifetime retirement income while maintaining flexibility and liquidity from a retirement account is to use a combination of purchases of immediate life annuities and withdrawals from a dynamically changing investment portfolio. Federal tax law should encourage this broad strategy, providing individuals with financial security for the whole of their retirement.