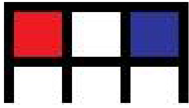

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How does a structured settlement annuity differ from the fixed annuities offered through banks, stock brokers and insurance agents?

Structured settlement annuities and other widely marketed fixed annuities have some basic similarities but, for the most part, are totally different.

Both types of annuities are offered through life insurance companies and are guaranteed by the company that issues the policy. Both types of annuities are designed to provide income in one form or another. Both types of annuities have an interest rate that is credited to the policy. That's about where the similarities end.

The differences are many and we will address only the most significant ones. The first difference is why each type of annuity came into being. Fixed rate annuities (FRAs) appeared in the first half of the 1900s. They were marketed as safe, retirement savings vehicles. Structured annuities came into being around 1980 and were specifically designed to be used in the settlement of physical injury claims, particularly in cases involving minors to protect their money until they reach the age of majority.

Next, while anyone over 18 years of age is eligible to purchase a FRA, only individuals (and/or their immediate family members) who have been physically injured can participate in a structured settlement.

The tax treatment of the income paid out of the types of annuities is a huge difference between the two. With the FRA, income taxes are only paid on the interest earned in the policy as it is paid out. This is why FRAs are also referred to as "Tax-deferred Annuities."

There is no income tax due when the original dollars invested in the FRA are paid out because the annuity is purchased with after-tax dollars and it is considered a return of principal. Any funds withdrawn from an FRA prior to age 59 and one half (unless the contract has been "annuitized") are considered interest income and are subject to income taxes plus a 10% IRS penalty.

Everything paid out of the structured annuity is tax-free. This highly favorable tax treatment is covered in Section 104(a)(2) of the Internal Revenue Code. Structured annuities are the only annuities in existence that are totally tax-free.

How funds are paid out of the two types of annuities is very different. The FRA has an "accumulation phase" (growth period) and a "distribution phase" (income period). When the policy owner decides to begin taking payments from the policy (annuitization) the life insurance company will provide several options as to how they will pay the money out. The policy owner has to select one of these options, they have no other choices.

With the structured annuity there is an almost infinite range of payout possibilities. The income stream can be tailored exactly to the anticipated needs of each individual.

Interest rates of FRAs are, basically, simple interest rates and are driven by current bond market interest rates. The life company determines the initial guaranteed rate based on available market rates, the rate of return on their existing investment portfolio and how much they are willing to spend to attract new money. Rates credited after the initial guarantee period expires are often lower than the initial rate.

Interest on a structured annuity is quite different. There is no accumulation phase for a structured annuity. They are only about distribution.

The life company knows exactly how much they have to pay out of the policy, when those payments are due and how much money they have to start with. They then determine how the premium needs to be invested to meet the payment obligations. The investment portfolio chosen determines the interest rate for the portfolio.

Because the investment portfolio has bonds with various maturity dates and interest rates, it is difficult to come up with an exact "interest rate" that could be easily compared to the FRA rate. Instead they have to use a "Net Present Value" calculation which generates an "Internal Rate of Return." The "IIR" provides a reasonable basis to compare the rates on a structured annuity and an FRA.

Actually, the best way to compare rates between the two is by using the FRAs "annuitization" rate and comparing it to the SS IIR,

The FRA has some limited liquidity options, but there are income taxes to be paid on withdrawals and the 10% IRS penalty if money is taken out prior to age 59 and one-half.

The structured annuity is very illiquid. A partial or total early liquidation of a structured annuity requires court approval. If a partial or total liquidation is approved the money is paid to the claimant tax-free, but it is at a discount from the actual value of future payments.

Think of it this way: If I am to receive a guaranteed payment of $25,000 in five years, what might someone pay me for that today? It certainly would not be the full $25,000. The amount of money you need to invest today to guarantee a $25,000 payment in five years would be based on interest rates today and would be less than $25,000 because it would have five years to grow. The further in the future a payment is, the less it is worth today. Another way to say that is that the present value is less than the future value.

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