Things to check before buying a deferred annuity plan.

The scheme offers regular income after retirement, but there are caveats

Anagh Pal |28 Oct 2021, 12:15 AM IST

Deferred annuities are insurance products that are meant to provide you a regular income at a future date. There is the accumulation phase, where you make a payment for a certain number of years, and then a payout phase when you can choose to get a regular income. Hence, by nature, deferred annuities are for providing a regular income in retirement. However, that may not necessarily make it suitable for retirement purposes. If the agent selling you the annuity does not clearly tell you what you need to know, you might end up buying a product that is not suitable for you.

“Deferred annuity products are pitched as ways to ensure good income generation in retirement. Some of the problems that are there in insurance mis-selling would also apply here—like padding up returns, not informing annuities are taxable,etc," says Suresh Sadagopan, founder, Ladder7 Financial Advisories and a Sebi-registered investment adviser (RIA). Hence, it is important to have clear understanding of how deferred annuity products work.

IRR is important, not absolute numbers: The internal rate of return (IRR) is a metric that helps one make an estimate of how profitable an investment is. When calculating the IRR, the present value or the net present value of future cash flows is taken as zero. In other words, it is the effective interest rate you will be earning if you make an assumption that the money you earn out of an investment is equal in value in today’s rupees, to the money you invest to begin with. “The concept of IRR does not get enough attention and very often we do come across cases wherein absolute numbers are spoken about, which makes it challenging for investors to relate it to the time value of money and current discounted values," says Vishal Dhawan, founder and CEO, Plan Ahead Wealth Advisors, a Sebi RIA. “The IRR typically ranges between 5% and 7% per annum. It may be conveyed in certain cases, but not in all cases," he adds.

Inflation is the real villain here: Let us say that today your monthly expenses are ₹60,000. If you are 35 years old and want to retire at 60, you will require ₹2.57 lakh in the first month of retirement to maintain a similar standard of living, assuming that the inflation is 6%. Every month, the money you require will go up.

“A deferred annuity or any product offering regular returns should be evaluated based on the fact that the regular return is going to come at a much later point in life. Hence, one needs to consider inflation in the intervening period and see if the amount that would come in the future is a meaningful amount," says Sadagopan.

“It is also critical to remember that inflation will continue during the retirement years as well, so that also needs to be kept in mind," says Dhawan.

Currently, you are able to cope with inflation because your income increases year on year. Post retirement, that will not be the case. “It’s great to have a guaranteed income for life. But will the income offset inflation and taxes on year-on-year basis? If no, the product is not suitable for you," says Arijit Sen, co-founder of Mery Mind and a Sebi RIA.

You need to factor in taxes: There is no tax on the money invested until you withdraw it. Also, under Section 80CCC, you can claim a maximum deduction of ₹1.5 lakh per annum for deposits you make into an annuity plan from a life insurance company. However, the taxation on withdrawals is at the normal income tax rate, depending on the slab you are in.

To avoid being mis-sold a product, financial awareness is important. “As practising financial planners, we continuously focus on increasing the financial awareness among our clients," says Sen.

The primary thing is to understand what you need. “People usually need a regular income after retiring from work-life. But, how much? Will the regular income from annuity be sufficient? If yes, for how long can you survive on the regular annuity income? are questions you need to ask yourself," says Sen.

If you have asked yourself these questions and answered them, you won’t fall for an agent’s sales pitch.

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