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What is an Annuity and How Can I Decide if I Want One?

First, a caveat, I will be generalizing. Probably on every point, there is an exception or an insurance company that does things just a little differently.

My goal is to give you enough information to help you decide:

1. Would an annuity help you address your financial goals, and

2. Which features, or Riders, would you want to add to your contract?

It is a complex subject, and I would advise strongly doing additional research and/or talking with a financial advisor.

Annuity Basics.

In its simplest form an annuity is a contract between an insurance company and a client. The client pays the insurance company a lump sum or makes regular payments for a number of years. In return, the insurance company invests the money and at some point in time, often when the client retires, makes periodic payments to the client. The client gives up his or her principal in exchange for an income stream (periodic payments). This is called **annuitization.**

There are four parties to an annuity. On one side is the insurance company. On the other side, there are three people. First is the person who owns the annuity, and pays the insurance company. Second is the annuitant, the person on whose life the annuity is based. Third is the beneficiary, the person who receives the insurance company payments. These three can be the same person or different people.

In addition, there are two time periods to an annuity. The **accumulation period** is the time during which you are making payments and the annuity is, hopefully, rising in value. The second is the **payout period**. This is the time during which the insurance company is making periodic payments to you.

Two of the three types of annuities we will discuss are considered financial products that mix stock and bond market investments and insurance. Those who sell them must be registered or licensed for both securities and insurance. The third type is a fixed annuity, with a guaranteed investment return for a specific term, for which one only needs an insurance license to sell.

Three Basic Types of Annuities.

There are three basic types of Annuities: Fixed, Variable and Equity Indexed.

A **Fixed Annuity** is an insurance contract in which the insurance company invests in a fixed income investment, like a bond, Certificate of Deposit or the General Fund of the company, and at a later date makes fixed dollar payments to the annuitant for the term of the contract. The insurance company guarantees the payments. You usually know how much the payments will be when you purchase the contract.

A **Variable Annuity** is an insurance contract in which the insurance company sets up a sub account for the owner. Subaccounts are portfolios available within the annuity that most often invest in a basket of mutual funds. At the end of the accumulation stage, the insurance company guarantees a minimum payment. The remaining income payments can vary depending on the performance of your separate sub account (portfolio). The amount you accumulate will depend on the performance of your sub account. The amount of your payments can be fixed or vary after annuitization.

An **Equity Indexed Annuity** is an alternative investment to a traditional fixed rate or variable rate annuity. Equity-indexed annuities are distinguished by the interest yield return being partially based on an equity index, such as the S&P 500 Index. The amount you accumulate and the amount you receive in payouts will vary depending on the performance of the chosen index. Typically, you will receive a percentage of the rise in the index, or your gain may be capped. In return, the insurance company puts a floor on your potential losses.

That seems pretty straight-forward, so why do they seem so complicated?

Annuities are complicated for a variety of reasons. First, because during the accumulation period of Variable Annuities you may have dozens of mutual funds, equity and bond investments to choose from to put in your sub account. So each sub account is unique. Second, there are a variety of options, or Riders, to customize your annuity. So each annuity may have different options.

A second major reason annuities seem complicated is because you annuitize. To annuitize is to lock-in your (monthly or quarterly) payments, typically when you retire. Annuity payments are made from units. With the money you have accumulated in your sub account, you buy units. Then each unit pays so much.

The vast majority of annuity owners choose a fixed annuitization, in which payments never vary. Your last payment is the same as your first. A few owners choose a variable annuitization, in which payments vary with the performance of their sub accounts.

So why annuitize?

There are a few reasons why an annuity owner would want to annuitize his or her contract. First, annuitization sets up predictable periodic payments. The owner knows how much he or she will receive and when (monthly or quarterly, for example). Second, there may be a tax advantage.

With a **non-qualified annuity** (purchased with after tax money), after you annuitize some of your payment will be excluded from taxes. Part of the payment is considered return of principal, which has already been taxed, and part is considered growth and earnings, which has not yet been taxed. The company will tell you the percentages of each type of income.

In contrast, withdrawals from a non-qualified annuity (purchased with pre-tax money) that has not been annuitized are taxed in their entirety as ordinary income.

With a **qualified annuity**, purchased with pre-tax money, upon withdrawal it is all taxed as ordinary income, like your traditional IRA.

You want to be sure you understand annuitization before you purchase your annuity.

The exception to all these complexities might be the fixed annuity, in which oftentimes you know ahead of time how much you will receive monthly, for how long, and what percentage is not taxed and what percentage is taxed.

Annuity Riders

The first annuity contracts offered by insurance carriers over a century ago were relatively simple instruments. They were designed to insure against the risk of outliving your income, and provided a guaranteed income stream to annuitants in return for either a lump-sum or periodic investment. But annuity contracts have become increasingly complex over the years.

Variable annuities were introduced in the 1980s. Because these vehicles now house billions of dollars in retirement assets for both individuals and corporations, the importance of asset preservation within them has become a critical issue. This has led to the creation of a number of special **insurance riders** that provide several different types of living and death benefit protection to contract holders.

Typical Riders

There are a handful of basic annuity riders that you should understand. The first is the **Automatic Step-Ups or Guaranteed Minimum Accumulation Benefit.** During the accumulation period, the insurance company may guarantee a certain annual return for a certain period of time, often five or ten years. Both the amount guaranteed and the term may vary from contract to contact and from company to company. If your sub account increases more than the guarantee that year, for example, that is what you get. If your sub account increases less than the guarantee, you get the guarantee.

Living Benefits are benefits (payments) paid to you while you are alive. The most common is the **Guaranteed Minimum Income Benefit (GMIB).** These riders guarantee a minimum income stream once you annuitize, even if your underlying investments have done poorly. This is the insurance part of the contract.

A second common living benefit is the **Guaranteed Minimum Withdrawal Benefit (GMWB).** These riders allow annual withdrawals up to a pre-determined percentage of the current value of the annuity's portfolio for a set period of time. With a GMWB you can receive regular income without annuitizing your contract.

A third common rider is the **Death Benefit or Premium Refund.** With many annuities when you die after payout begins, the undistributed balance of the principal in the account reverts to the insurance company. For a fee, the Death Benefit Rider will return any uncollected principal to your beneficiary. For example, if you purchase a $100,000 annuity and collect $75,000 before you die, your beneficiary gets the remaining $25,000.

If you die before you begin taking benefits, many policies will refund your payments to your beneficiary. Be sure to check this. Oftentimes there is no extra charge.

Another useful rider is the **Long-term Care Rider.** A Long-term Care rider is a provision that can be added to many insurance policies and annuity contracts to provide coverage for long-term care that would otherwise not be covered in the primary contract. Should an annuitant require long-term care, and meet the policy criteria, this rider allows the annuitant to make withdrawals from the account without incurring surrender charges for a set number of months, or, in some cases, for the remainder of their lives. And because this is not medical insurance, a purchaser does not need to pass a medical exam.

Payout Choices

Typically, the purchaser of an annuity has two basic choices when deciding on payout options. First, when does the insurance company start payments to the beneficiary of the annuity? With an **Immediate Annuity,** the insurance company begins making payments the next month. Such annuities are purchased with a lump-sum payment. With a **Delayed Annuity,** payments are delayed, usually until retirement, and the investments in the contract grow tax-deferred over time. This type of annuity generally is purchased with regular payments over many years.

Second, the purchaser chooses for how long the annuity will make payments. With a Single Life Annuity, payments last until the annuitant (person insured) dies. With a Joint Life Annuity, payments last until the second spouse dies. Joint Life Annuities usually pay less per month. Finally, with a Period Certain Annuity, payments last for a fixed number of years, typically 10, 20, 25, then end. If the annuitant dies before the period certain expires, the remaining years are paid to the beneficiary.

So what does all this cost?

Most annuities carry three types of charges. First, there is the cost of Riders. Typically, these run from 50 to over 100 basis points per benefit. A basis point is one-hundredth of a percent. So a 50 basis point cost would be one-half percent.

Second, there are Administrative costs, or **Mortality and Expense Risk Charges (M&E)**. These fees apply to all annuities, as well as life insurance. They are the fees that pay for the insurance guarantee, sales commission and administrative costs of the annuity contract. These can range from one to three percent. In a variable annuity, these are in addition to the asset management fees in the subaccounts.

The third cost is what is known as **Surrender Charges.** This feature is to encourage annuity owners to stay in the annuity a long time. If an annuity is surrendered during a window of typically seven years, the fee will apply. The earlier the surrender, the greater the fee charged.

So, the total cost for a typical Variable Annuity can vary from approximately two to four percent. But remember that you are getting guarantees that are not available with other investments. And you choose which ones you want. Be sure to ask your financial advisor to explain all the fees and benefits to make sure they make sense for your situation. This is key. If you do not understand, ask again.

Note that some companies now offer bare-bones annuities with lower costs, especially for an immediate fixed annuity.

Tax Treatment of Annuities

For tax purposes, there are two types of annuities, depending on the money used to purchase them. First, there are **Qualified Annuities**. These are purchased with pre-tax dollars, money that has never been taxed. So it is fully taxable as you take money out. Like a traditional IRA. Second, there are **Non-Qualified Annuities**. These are purchased with after-tax dollars. So while it grows tax-deferred, when you take money out, the earnings, but not your initial investment, are taxed at your marginal rate. They are not taxed as capital gains.

Each year that you take payments of any type the insurance company should send you a 1099 for the contract.

Why would I want one, they seem expensive?

There are some very good reasons to buy an annuity. First, it allows you to create an account that can grow tax-deferred. Tax-deferral has the potential to make a huge difference in the amount you have after ten or twenty years versus an account from which you withdraw money to pay taxes on the dividends and gains every year.

Second, an annuity with a lifetime payout also can be a Guaranteed Income that you cannot outlive. It is sometimes called longevity insurance.

Third, an annuity can provide a **Surviving Spouse** with a continued guaranteed income for life. This can be appropriate if the surviving spouse is not financially savvy.

Fourth, an annuity can be very useful when leaving money to a **Special Needs** beneficiary of your estate. If the person is receiving benefits that would be jeopardized by having too much money, an annuity can help avoid this. The beneficiary is not necessarily the owner.

Fifth, an annuity can be used to leave money to a "financially challenged" beneficiary. The beneficiary cannot blow the entire amount, just the monthly or quarterly payout.

Sixth, putting a portion of your portfolio in a fixed annuity can provide you with a stream of income that is not tied to the performance of the stock or bond market, a form of diversification.

Finally, an annuity can be a back door into some Long-Term-Care insurance. Some annuities will allow you to withdraw two or three times your "normal" distribution under a LTC rider. There is no medical exam.

To sum it up

Remember, however, that all guarantees are based on the claims-paying ability of the issuing insurance company. Withdrawals taken prior to age 59 ½ may be subject to a ten percent penalty tax. And, variable annuities are subject to market risk and may lose value.

Now that you have a basic understanding of how annuities work, you can ask intelligent questions about them and make an informed decision before you buy. But be aware that each insurance company puts its own little twist on its annuities making it difficult to compare different contracts.

And yes, I sell these. I would be more than happy to meet with anyone who is interested, or just curious.

Thanks.

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Disclosures:

Variable Annuities are suitable for long-term investing, such as retirement investing. Withdrawals prior to age 59 ½ may be subject to tax penalties and surrender charges may apply. Variable annuities are subject to market risk and may lose value.

Fixed annuities are long-term investment vehicles designed for retirement purposes. Gains from tax-deferred investments are taxable as ordinary income upon withdrawal. Guarantees are based on the claims paying ability of the issuing company. Withdrawals made prior to age 59 ½ are subject to a 10% IRS penalty tax and surrender charges may apply.

Equity Indexed Annuities (EIAs) are not suitable for all investors. EIAs permit investors to participate in only a stated percentage of an increase in an index (participation rate) and may impose a maximum annual account value percentage increase. EIAs typically do not allow for participation in dividends accumulated on the securities represented by the index. Annuities are long-term, tax-deferred investment vehicles designed for retirement purposes. Withdrawals prior to 59 ½ may result in an IRS penalty, and surrender charges may apply. Guarantees are based on the claims paying ability of the issuing insurance company.

Riders are additional guarantee options that are available to an annuity or life insurance contract holder. While some riders are part of an existing contract, many others may carry additional fees, charges and restrictions, and the policy holder should review their contract carefully before purchasing. Guarantees are based on the claims paying ability of the issuing insurance company.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor

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