

What is an annuity? — The basics

Part 1 of 8

You may be considering an annuity, and, if that's the case, it is important that you know what an annuity is — and isn't. Basically, an annuity is a contract with an insurance company — a long-term investment for future retirement income. An annuity will make income payments to you at regular intervals in return for the premium or premiums you have paid.

A popular feature, and one that is unique to annuity contracts, is the lifetime payout option. Yes, an annuity contract can offer you an income stream in retirement that you cannot outlive. Generally, you may choose from a variety of payout options when you're preparing to receive payments from your annuity — the lifetime option being just one. Your annuity payments are guaranteed by the insurance company from which you purchased your annuity, so be sure you investigate the strength and claims-paying ability of the company you choose.

The federal government allows annuities to earn interest tax deferred —and that's to encourage individuals to set aside money for retirement. Annuities are designed to be long-term contracts — they are not appropriate for short-term investment goals. In fact, early withdrawals can incur federal restrictions and tax penalties.

The market offers a dizzying variety of annuity types. You can almost certainly find an annuity to serve your individual needs. But that also means you can wind up with the wrong product if you don't research and ask questions. In our next installment, we'll begin to explore annuity types.

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What is an annuity? — Tax-qualified or not? Deferred or immediate?

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Before purchasing an annuity, you should learn the types that are available. There are qualified annuities and nonqualified annuities, fixed annuities and variable annuities, deferred and immediate annuities. Knowing the characteristics and advantages of each can help you more effectively plan for your future income needs.

What makes an annuity “qualified” or “nonqualified”?

Qualified annuities are funded with pretax dollars — that means income tax has not been withheld from the money in a qualified annuity account. Generally, qualified accounts are funded by contributions to your employer’s workplace retirement plan [such as a 401(k), 403(b) or 457(b) plan] or to an IRA. You may contribute up to a maximum amount specified under the Internal Revenue Code each year. In 2010, that amount is \$16,500. Internal Revenue Code also specifies that you begin withdrawing money when you reach age 70½ or, in the case of employer-sponsored plans, when you retire if that is later.

Nonqualified annuities are purchased with after-tax dollars — that means income tax withholding has already taken its bite. They don’t have the contribution limits you find with qualified annuities; in fact, you can contribute up to \$1 million annually to a nonqualified annuity in some cases. Also, federal law doesn’t specify when you must begin receiving income from a nonqualified annuity.

Deferred or immediate? Depends on your investment objective.

Deferred annuities are built around two phases: accumulation and payout. During the years you’re setting money aside, tax deferral can help your savings accumulate faster, since money that would have gone toward taxes can stay in your account and grow through tax-deferred compounding. Of course, income taxes are payable on withdrawal. And if you withdraw money before you turn age 59½, you may incur federal restrictions (for qualified contracts) and a 10% federal early withdrawal penalty in addition to the income taxes.

With an **immediate annuity**, you can convert assets to an income stream that starts right away (if under an employer-sponsored plan, the plan must permit this). For example, you can purchase an immediate annuity with a single payment and start receiving income usually within 30 days and no later than 12 months.

Read about more annuity types in Part 3.

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What is an annuity? — Fixed or variable?

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Do you need guaranteed return or the potential for growth?

A **fixed annuity** provides a guaranteed return — generally paying a set amount of interest. During the accumulation period, your money earns interest at rates set by the insurance company. The insurance company, backed by its claims-paying ability, guarantees it will pay no less than a minimum rate of interest. These interest rates are usually reset annually and guaranteed for one year.

A **variable annuity** offers the potential for greater investment growth than a fixed annuity. While the return amount can vary, depending on the performance of the investment options chosen, you could have a better chance that the income stream will stay ahead of inflation.

With a variable deferred annuity, you pay premiums to the insurance company during the accumulation period, and the company places those premiums (less any applicable charges) into a separate account. You select the investment options in which your money is invested according to your tolerance for risk.

Variable option values (stock funds, bond funds) will fluctuate so that your investment units, when redeemed, may be worth more or less than their original cost. So with a variable annuity, you have the opportunity for higher returns, but that comes with a higher risk. In other words, you can possibly lose some of your principal investment with a variable annuity, but generally, fixed annuity principal is guaranteed.

Read about more annuity types in Part 4.

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What is an annuity? — Index annuities, and single- or multiple-premium?

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The indexed annuity: a compromise between fixed and variable

In addition to fixed and variable annuities, there's a third option: **indexed annuities** (also known as equity-indexed annuities). This type of annuity has characteristics of both fixed and variable annuities, but the return typically varies more than with fixed options — and not as much as with variable options.

During the accumulation period, you make a lump-sum purchase or pay a series of premiums to the insurance company, which credits you with a return based on values in a stock index such as the S&P 500 Composite Stock Price Index. Indexed annuities have the potential to earn better returns than fixed annuities when the stock market is rising. They also have a minimum return guarantee, backed by the insurance company's claims-paying ability, which insures a minimum return in a down market.

Single- versus multiple-premium annuities

A **single-premium annuity** is purchased with one payment to the insurance company. Conversely, a **multiple-premium annuity**, as the name implies, is purchased through a series of payments. There are two ways to purchase a multiple premium annuity:

- **Flexible premium** – Within set limits, you decide how much to pay and when to pay it.
- **Scheduled premium** – The annuity contract specifies the amount and schedule of your payments.

Either way, you decide when to begin receiving money. You also decide the form of the payments. Your choices include the following:

- Systematic withdrawals
- Random withdrawals
- Annuitization for scheduled payments

Read about more payout options in Part 5.

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What is an annuity? — Before you withdraw ...

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Know what surrender charges are in your annuity contract. Most annuities allow free withdrawals, but if you withdraw funds from your annuity before allowed by your contract, you may have to pay a penalty fee or surrender charge. Generally, you are only penalized on the amount withdrawn over the free withdrawal amount.

The surrender charge period typically lasts from five to 10 years after the annuity is purchased. The charge, which may apply to the contract as a whole or separately to individual purchase payments, frequently decreases to zero as the annuity nears the end of the withdrawal charge period. Withdrawal/surrender charges can reduce the value of your investment.

When time comes to consider your payout options ...

Here's a term you should know, to **annuitize** is to convert the funds in your annuity into a series of payments. Annuities offer a large variety of payout options. It's a good idea to learn about your payout options so you can choose the option that will work best for you. And bear in mind that you can choose an option that will provide a retirement income you cannot outlive.

When deciding your payout option, you must consider whether you want to annuitize all or only a portion of your account balance – and also how often you want to receive payments. The value of an annuity is the sum of premiums you have paid, plus the interest and/or earnings that have been credited minus any charges and withdrawals. This value is used to calculate the amount of most benefits you will receive.

Retirement income payout options to consider

When you select an annuity payout option, generally you have the following choices:

- How often to receive payments
- Whether to annuitize all or only a portion of your account balance

Be sure to discuss these options with your financial advisor, because annuitization is an irrevocable election. You may also choose between a fixed or variable payout option.

- **Fixed payout option** – Your cash value is used to fund a fixed payout.
- **Variable payout option** – This provides scheduled benefit payments and the potential to achieve investment growth that has historically outpaced the cost of living. Your payment amount will fluctuate according to the performance of the investment options you select and the assumed interest rate you chose.

To minimize investment risk and maximize returns, consider combining fixed and variable payout options. We'll talk about lifetime income payout options in part 6.

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What is an annuity? — An income stream you cannot outlive

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Possibly the most popular annuity provision is the ability to choose a payout option you cannot outlive. Within this category, you have several choices including the following:

- **Life only** – This option makes payments as long as you live, but makes no payments to a beneficiary. However, the “life only” option usually pays the highest income possible.
- **Life with period certain** – This option makes payments as long as you live. Should you pass away before the end of the “period certain,” the insurance company will make payments to your beneficiary for the remainder of the period. The period is generally 10 or 20 years.
- **Joint and survivor** – This option makes payments as long as either you or your co-annuitant or beneficiary lives. If you wish, you can specify a reduction in the payout amount after the first death.

Other payout options are available that pay income for specific periods but are not guaranteed for life. Annuitizing prior to age 59½ could cause the annuity payments to be reduced by the 10% federal tax penalty for premature distribution, unless the payments are made over one or more life expectancies.

We'll look at other payout options in part 7.

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What is an annuity? — Different payout options

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As mentioned previously, annuities offer a large variety of payout options. We've already covered lifetime payout options, but there are other options you might find more suitable, including the following:

- **Partial withdrawals** – This option allows you to receive partial withdrawals from your retirement account while the remaining account balance continues to grow tax deferred. This option can help you meet certain financial needs if you aren't yet ready to receive scheduled distributions.
- **Systematic withdrawals** – This option, an alternative to annuitization, lets you receive income automatically at specified intervals, but you still maintain access to your accumulated retirement account balance. Generally, you can make systematic withdrawals by:
 - Specified dollar amount,
 - Specified percentage,
 - Substantially equal periodic payments, or
 - Five-year payment method.
- **Single-sum (lump-sum) distribution** – This option allows you to withdraw all funds from your retirement account in a single, lump-sum payout. Bear in mind that previously untaxed contributions and earnings in the account will be taxed as ordinary income, and may be subject to surrender charges. In addition, the payout could be subject to mandatory 20% federal tax withholding, plus a 10% federal tax penalty if you are under age 59½. Consider also that withdrawing all funds at one time could possibly push you into a higher income tax bracket in the year of withdrawal, exposing you to increased federal taxation. You may want to consult with your tax advisor before taking a lump-sum distribution.

With all the annuity payout options available, there's almost certainly one to suit your situation.

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What is an annuity? — Final notes

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As we have discovered in this series of articles, annuities come in “all shapes and sizes.” Once you become familiar with the many options available, it’s easy to see how you can customize an annuity to suit your needs. Here are a couple more options you could consider. The first concerns the accumulation phase; the second concerns your distribution options.

Guaranteed Minimum Withdrawal Benefit (GMWB)

Some annuity contracts offer a living benefit option known as a guaranteed minimum withdrawal benefit. Clients who have purchased an annuity can add the GMWB option for an additional fee to help protect their income stream in retirement against market downturns. With this option, the annuity owner can receive an income stream each year regardless of their account balance. And the guaranteed minimum withdrawal benefit protects the income stream against possible market downturns without missing out on potential market gains.

Leaving funds on deposit

If you don’t need retirement income immediately or if you want to preserve capital for your estate, you might be able to leave your retirement funds on deposit. The benefit? Your account can continue to grow tax deferred until you withdraw it for retirement income needs or required minimum distributions.

Which annuity is best for you?

Given the many annuity choices open to you, it’s important to clearly understand the features and trade-offs that characterize different annuities. When you make a comparison of various annuities, make sure you compare all of the features that each annuity offers. Then decide for yourself which combination of features makes the most sense to you.

Be sure to read your annuity contract carefully when you receive it. As always, the best financial decisions are informed decisions. So if there’s anything about your contract you don’t fully understand, ask your annuity provider’s representative or financial advisor to explain it to you.

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