

# ANNUITY OVERVIEW

## INTRODUCTION

An annuity is a contract that provides a predetermined series of income payments in return for an initial investment. The purchaser (annuitant) can make an initial investment in the form of a lump sum or a series of payments. The income payments (distributions) can be a guaranteed, fixed amount or an undetermined amount based on market returns on the initial investment. The duration of the income payments can be a set number of years or last the life time(s) of one or two people. Annuities are the only investment type that provides a lifetime income guarantee.

Annuities are sold as stand alone investments, usually by insurance companies. The foundation for the annuity is a concept called the Time Value of Money (TVM), which is a fancy term for the many nuances of compound interest. The basic concept of TVM is that any series of future cash flows is equal to a current lump sum amount of cash. These future cash flows are said to be discounted to the present. The discount rate is the assumed interest rate. The higher the interest rate is, the lower the current value of future cash flows. Insurance companies make assumptions about interest rates and use actuarial tables as inputs to TVM calculations to determine what price must be charged for an annuity in order to cover future income payments, provide commissions to brokers, and allow for profits to the insurance company.

## ANNUITY TYPES

**Immediate annuities** start paying income payments right away for an investment, today. This type of annuity is a viable option for retirement plan distributions. For example an investor could take a lump sum distribution from an IRA or 401(k), purchase an immediate annuity, and begin receiving a guaranteed income right away. There are several options for receiving income, and these are covered in Settlement Options Section.

**Tax-deferred annuities** do not start making income payments until sometime in the future. The proceeds from the sale of the annuity that are not used to pay commissions are invested. At a future date the income payments are made to the annuitant. Each payment is made up of two components: (1) the original investment and (2) returns on the investment. The annuity is combined with life insurance. Earnings on the invested portion are not taxed as long as a portion of the investment is used to purchase insurance and the insurance stays in force. The annuity investment must also be diversified per IRS rules.

## INVESTMENT OPTIONS

**Fixed annuities** are managed by the issuer (insurance company) and guarantee a future fixed payment. The insurance company assumes all of the investment risk and invests in a broadly diversified portfolio of securities. The investor accepts a rate of return that is much lower than historical market averages in exchange for having the insurance company assume market risk and provide a guaranteed return. The investor

is still exposed to default risk associated with the insurance company. If the insurance company goes bankrupt, investor funds could be lost or tied up for some time.

**Variable annuities** are managed by the purchaser by selecting among various mutual fund options. The available fund choices are usually very limited and restricted to broadly diversified mutual funds. The investor assumes the market risk in exchange for potentially higher returns. The investor's funds are segregated from the insurance company's assets so there is no exposure to the risk of insurance company default.

**Equity-Indexed annuities** are a newer type of deferred annuity that provides a minimum guaranteed investment return while allowing for potentially higher returns based on performance of stock market indexes. There is a sharing of market risk and returns between the insurance company and the investor. Funds are not segregated so there is exposure to insurance company default.

## SETTLEMENT OPTIONS

Whether an annuity is purchased as an long-term investment product or as a distribution option for a retirement plan, there are several settlement (distribution) options available:

- **Cash option** provides a single lump sum or a fixed series of payments
- **Life annuity** provides income payments as long as the annuitant remains alive. No additional payments are made after the annuitant dies.
- **Life annuity with guaranteed payments** provides the annuitant a guaranteed number of payments for periods such as five, ten, fifteen, or twenty years. If the annuitant dies before the end of the guaranteed period, the remaining payments are made to a beneficiary. In exchange for the guarantee regular payments are lower than if they are not guaranteed.
- **Installment refund annuity** pays a life income to the annuitant. If the annuitant dies before receiving the total purchase price of the annuity, the remainder goes to a designated beneficiary. Again this option will pay less than a standard life annuity.
- **Joint and survivor annuity** pays income on the lives of two annuitants such as a husband and wife. These payments continue until the death of the second person. Again these payments will be less than a standard life annuity. In addition, some plans may reduce payments substantially after the death of the first annuitant.

## SUITABILITY FOR INVESTORS

Annuities may be appropriate investments if you meet most of the following conditions:

- A guaranteed future income stream, especially one that will last for life, is desired.

- You plan to hold your investment for 15 years or more to recoup upfront costs and avoid surrender fees.
- You do not require distribution of funds to begin until age 59 ½.
- Investments in tax-deferred investment choices such as 401(k), 403(b), or IRAs have been maximized.
- You are willing to accept only mutual funds as investment choices.
- Today you are in a high income tax bracket but expect to be in a lower bracket upon retirement.
- You need to pass money to an heir without going through probate.

## DISADVANTAGES OF ANNUITIES

- The biggest disadvantage to annuities is fees, fees, and more fees. Up front commissions reduce the amount invested, and total annual fees for annuities average 2%. Annuities invested in equity mutual funds have even higher annual fees. High surrender fees are also charged for early withdrawal of funds.
- Insurance costs are high in comparison to purchasing inexpensive no-load or low-load term insurance.
- Investment choices are limited to vanilla mutual funds.
- Annuities lack total liquidity although many allow for limited withdrawals.
- Like retirement accounts earnings are taxed at regular income levels upon withdrawal, but initial investments are not tax deductible.
- Lump sum distributions may result in a significant tax burden.

## TAX CONSIDERATIONS

### INSTANCES WHERE TAXES ARE AVOIDED OR REDUCED

- For variable annuities the income accumulated is not taxed during the accumulation period. Investments in the variable annuity must be diversified per IRS regulations in order to receive this tax deferred status.
- When a beneficiary receives a remainder, this is usually the return of principal of the original investment and is not taxed. A remainder is the portion of the original principal invested by an annuitant that has not been paid back as a part of income payments.
- For the surviving annuitant of a joint and survivor annuity, there may be a

deduction to the extent that any estate or generation skipping taxes were owed in the estate of the first to die.

- If a life annuitant dies before initial costs are recouped, an itemized loss deduction is available.

#### **INSTANCES WHERE TAXES ARE OWED**

- When an annuitant takes a partial withdrawal and accepts a reduced payment over the original distribution period, the withdrawal will be subject to income tax.
- When a partial withdrawal is taken but the payment remains the same and the distribution period is shortened, then tax will also be due if the surrender value of the contract exceeds the original investment.
- When the annuitant receives payments, the portion of the payment that is credited to the initial investment is not taxed. The rest is considered an investment return and is taxed at ordinary tax rates.
- Premature distributions may be subject to a 10% tax penalty.

#### **RECOMMENDATIONS**

A low cost immediate annuity may be a good alternative for older, conservative investors, who are taking distribution from a retirement account. However, be aware that conservative fixed income mutual funds have consistently provided higher income than annuities.

- For most investors other investment options with similar risk can provide the same income as annuities at lower costs.
- For those that like the death benefit component of annuities a low cost term life policy combined with other investments is a better alternative.
- Conservative investors interested in obtaining the guaranteed return of a fixed annuity over a fifteen year or longer period would be better served by investing in fixed income or equity investments. There has not been a fifteen year period in U.S. history when bonds or stocks have not provided a higher yield than is available through fixed annuities.
- If contributions to all other tax deferred retirement plans are maximized, and most of the other conditions listed above are met, variable annuities can make sense for a wealthy investor seeking additional tax deferred investment choices.

