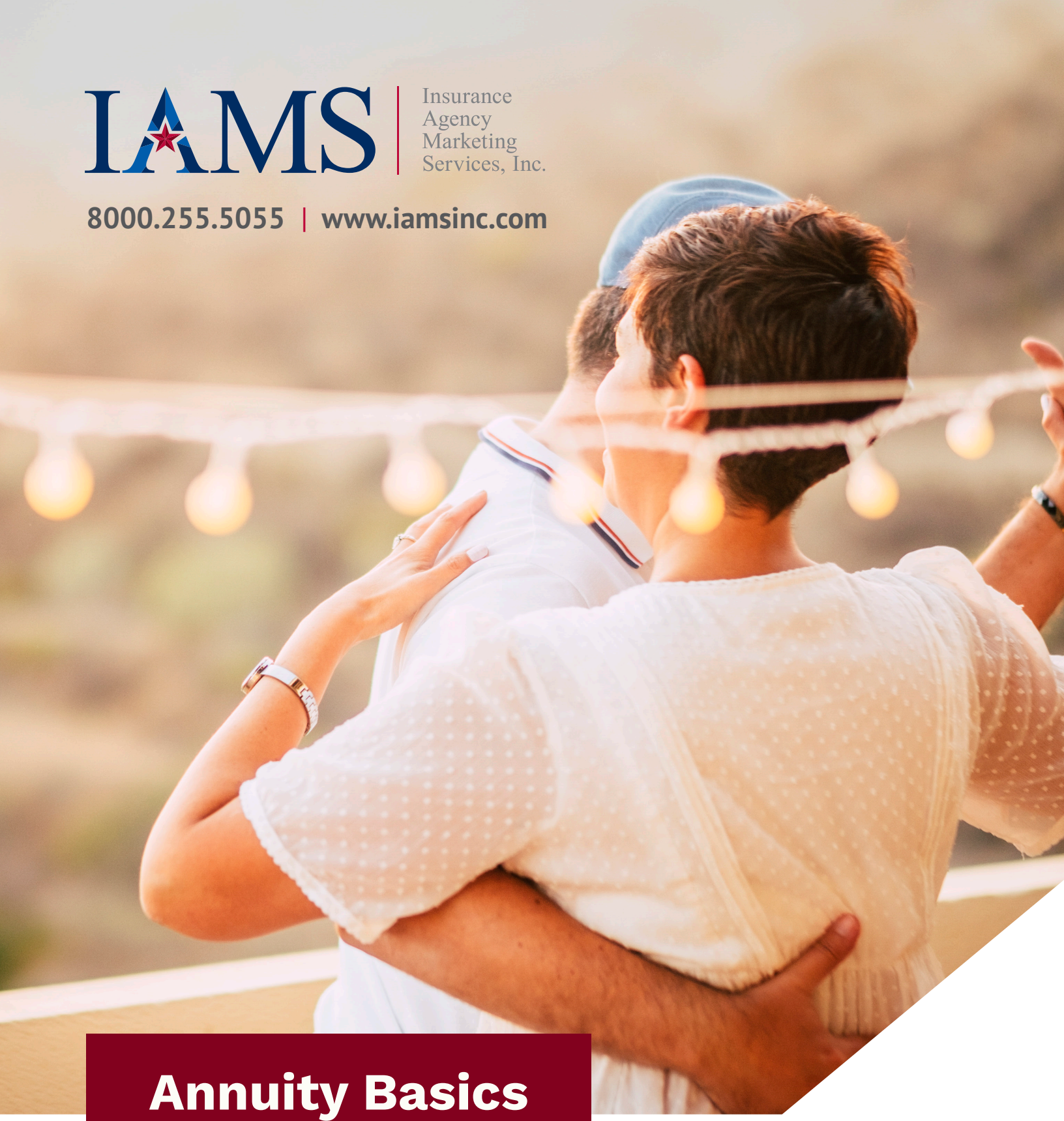
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Annuity Basics

Annuity Concept Overview

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Introduction

Planning for retirement can be stressful. For many, saving for retirement involves setting aside X amount of dollars for X number of years and hoping for the best. While this may sound like the simplest approach, it comes with a number of flaws that could easily see you outlive your savings.

For one, making consistent contributions to your savings account—and letting that money sit there untouched—can be a challenge. We've all had to dip into our savings to cover an unexpected/emergency expense. And we've all sacrificed a deposit into savings here and there for big ticket purchases or vacations.

Or, if you are a disciplined master at the art of savings, that still won't leave you immune to other obstacles that stand between you and a financially-secure retirement. Income taxes and inflation can both be a drain on your retirement income. And, with longer-than-ever life expectancies, more and more people face the very real threat of outliving some or all of their retirement income.

This guide will give a general overview of how annuities can be a viable solution for your retirement concerns.



OVERVIEW

When you purchase an annuity, you are investing into a long-term savings plan that can accrue assets on a tax-deferred basis and convert those assets into a steady stream of income. An annuity is similar to a life insurance policy in that it offers a layer of financial protection to the owner. However, where life insurance provides benefits to protect your assets (and those of your family) in the event of your premature death, an annuity protects against the financial implications of long life.

Generally speaking, an annuity works like this:

- You purchase the annuity by making a single premium payment or a series of installment payments
- The money accumulates on a tax-deferred basis
- At a later date, you receive benefits from the annuity, either in one lump sum or through periodic installments.

There are several different types of annuities. How premiums are paid, how premiums are invested, and when annuity payments begin are all factors that determine how the annuity is classified.

Overall, there are two basic categories of annuities—deferred and immediate. The main difference between the two is based on when you start to receive the annuity payments.



Deferred Annuities

When you purchase a deferred annuity, you are essentially setting up a fund that allows money to grow in value on a tax-deferred basis over a pre-determined period of time, usually several years. For retirement planning purposes, a deferred annuity can be a powerful financial tool that can offer the protection and guaranteed income you need to meet your goals.

A deferred annuity has two phases:

- Accumulation or Savings Phase – Also referred to as the "growth period," this is when you invest money into the annuity. During this phase, your assets accumulate on a tax deferred basis until the annuity start date.

- Income or Payout Phase – On the annuity start date, the value of your annuity converts to income that is paid out over the rest of your life, a specified period of time, or in one lump sum payment. Most deferred annuity contracts set the accumulation phase, or growth period, for at least 10 – 20 years. This gives your investment time to increase in value, resulting in higher payoust upon distributions and, most importantly, providing more financial security during your retirement years.

The growth period and annuity start date are typically established when you purchase the annuity. Keep in mind that the start date is when your assets automatically convert to income and payments begin. However, you can make partial withdrawals or surrender a deferred annuity for its value prior to the start date. Just be aware that doing either may result in additional fees and tax penalties. Review the terms of your contract or speak with your financial planner for details.



There are two options when it comes to paying into a deferred annuity. You can choose to purchase via a single premium or series of installment premium payments.

- Installment Premiums - Premiums are paid in a series of installments over a period of time, usually on a monthly basis. Your premiums can either be fixed or flexible. A fixed installment premium requires you to pay the same amount into the annuity each time. If you opt for flexible installment premiums, the amount you pay can vary, as long as each payment meets the contract limits. If you're someone who would feel more comfortable with having the option to make lower payments here and there, you might consider a flexible installment premium.

- Single Premium - You purchase the annuity by making one lump-sum payment, usually a minimum of $5,000 - $10,000. These are commonly used by people who use money from a retirement plan payout, settlement, or existing savings account to purchase their annuity.

Your annuity contract will include various fees and charges that will be deducted from your premium payments. Your financial planner will go over all costs associated with your specific annuity contract.

Immediate Annuities

An immediate annuity—also referred to as a single-premium immediate annuity (SIPA), income annuity, and immediate payment annuity—functions as you would expect from the name. Unlike a deferred annuity, an immediate annuity has only one phase—the income/payout phase. Here's how it works:

- You purchase the immediate annuity with a single premium payment. The minimum amount you can invest may vary depending on the contract, but most require a premium of at least $5,000.

- The payout phase generally begins within a year after purchase date, often in the first few months after purchase. Immediate annuities offer more or less the same payout options as deferred annuities.

Because there is no growth period, immediate annuity contracts cannot be surrendered, but some allow for partial withdrawals under certain conditions.

What's Right For Me?

After looking at the differences between deferred and immediate annuities, you might be asking, "Which of the two is the better option for me?"

The answer to that depends on your specific needs and situation. If you're getting a head start on retirement planning and still have several years to build a nest egg, you may want to consider a deferred annuity. Many see these as a reasonably safe way to maximize retirement income over a long period of time. Think of a deferred annuity like a savings account that, because of its tax-deferred growth, produces a much higher return on your investment.

Or, if you've reached the contribution limits on an employer-provided retirement plan and want to continue saving on a regular basis, a deferred annuity could be a good way to invest that money.

Those who have already retired or will soon might benefit from sinking their existing pool of cash (from savings, 401k, pension, settlement, etc.) into an immediate annuity to convert that money into a lifetime stream of income.

Another factor to consider when deciding which type of annuity to buy is how your premiums are invested. Premiums paid into both deferred and immediate annuities can be invested in a variety of ways, each with its own set of advantages and disadvantages. There are three basic options that you can choose from when deciding how to invest your premiums:

- Fixed Annuities
- Variable Annuities
- Indexed Annuities



Comparing Fixed, Variable & Indexed Annuities:

Fixed Annuities

This is a low-risk annuity that accrues value though fixed rate of interest investments made by the issuing company. Both your principal and minimum interest rate (typically 3-5%) are guaranteed throughout the duration of the annuity contract.

Additionally, the issuing company may pay a bonus interest rate that is guaranteed for a shorter period, usually several months to a few years. A fixed annuity offers a lower growth rate and might not shield your investment from inflation. However, they are generally safer than other options in that your money is protected from stock market volatility.

Fixed Indexed Annuities

With a fixed indexed annuity (sometimes referred to as an equity-indexed annuity), cash value accumulates based on the performance of specific stock market index, such as a S&P 500 or the Dow Jones Industrial Average. While tied to a stock market index, the annuity has no direct participation or exposure to the market.

Variable Annuities

After the issuing company takes any fees or charges out of your premiums, the remainder is placed into one or more equity-based investments of your choosing. These can be stocks, bonds, money markets, etc. These are higher risk than fixed annuities as the value is not guaranteed and depends on the performance of your investments. The trade-off for exposing your investment to market volatility is the potential for more growth and better protection against inflation.



Annuity Payout Options

When using an annuity as part of your plans for a financially-secure retirement, it's important to understand the different options you have when it's time to start receiving your payments. The choices you make on or before the benefit trigger date will directly impact the source of income that's meant to last the rest of your life. Carefully consider the following options:

Lump Sum

This option allows to "cash in," or surrender your deferred annuity and convert the accumulated assets into one lump-sum payment. However, you will have to pay income tax on the annuity earnings for the year in which you receive the payment. Another disadvantage with the lump sum option is the increased likelihood of outliving your income.

Systematic Withdrawal

This allows you to choose the fixed amount of money that will be paid to you on a regular basis until the assets accumulated by the annuity are gone. One advantage of this plan is that it offers some flexibility in regard to how often you receive payment. A systematic withdrawal plan can provide you with a consistent source of money during your retirement years but does not guarantee you won't outlive that income.

Be aware that any lump sum or systematic withdrawals made before the age of 59-1/2 years old may result ina 10% federal tax penalty on your earnings.

Both of the above options can be effective and powerful ways to obtain a source of retirement funds or supplement your existing income, but neither fully solve the problem of ensuring guaranteed lifetime income. A financially-secure retirement requires a consistent stream of income to give you the peace of mind that comes with knowing your living and medical expenses are covered for the rest of your life.



Lifetime Income Benefit Rider

The Lifetime Income Benefit Rider is an additional feature that may be purchased in conjunction with certain types of annuities. The rider guarantees income payments for as long as that policyholder is alive. This feature is designed to provide more financial security with annuities and is often a useful instrument to get more out of an annuity investment. With other riders and variations, it may be also possible to issue an annuity's remaining balance to surviving beneficiaries.

In simplest terms, the lifetime income benefit rider provides a steady stream of income upon triggering benefits, even after the accumulated cash value of the annuity is exhausted (provided this occurs per contract stipulations). This is because the parent annuity and the lifetime income benefit rider can be seen as two separate accounts, tied together in a unique and somewhat complicated relationship. The payout amount of the lifetime benefit rider is set by agreed-upon rates and age considerations. If you are considering purchasing an income rider on an annuity or think it might be a solution for you it is important to speak with a knowledgeable financial advisor as there are a number of variations with different carriers.

Considerations

While this guide provides a comprehensive, yet basic overview of annuities as a retirement planning strategy, the many variables and details involved leave much to be discussed. Our hope is that, by reading this, you have the tools necessary for a productive conversation with your professional financial planner about how annuities can prepare you for life after retirement.



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