



## Annuity Facts and Myths

An annuity is a contract between an individual or entity and an insurance company. In exchange for a premium, the insurance company guarantees a future payout for a guaranteed period of time. The purpose of an annuity is to provide a constant source of income for the life of the contract.

Life insurance protects against the risk of dying too soon. An annuity protects against the risk of outliving a source of income.

An annuity has two distinct phases: **Accumulation:** The phase in which an individual or entity puts money into the annuity. May be a single payment or be a series of payments over a period of years. **Distribution:** The phase when the accumulation is ended and the payout begins. Payout can be a lump sum or via a variety of terms to include a lifetime.

### Pros and Cons

Annuities have advantages and disadvantages which must be carefully weighted to determine if it is an appropriate investment tool.

Prime advantages include:

- 1) Tax deferred growth
- 2) Possible protection from creditors
- 3) Guaranteed growth
- 4) Lifetime income
- 5) Benefits passed to beneficiaries tax free
- 6) Avoidance of probate

Prime disadvantages include:

- 1) Fees and expenses
- 2) Surrender charges
- 3) Early withdrawal penalties and fees
- 4) Liquidity
- 5) Complexity of Contracts

- A deferred annuity, also called a savings annuity allows for tax-deferred growth of assets.
- An immediate annuity, also called an income annuity lets you immediately convert a portion of your saving into a monthly income stream.

Three major categories of annuities:

- 1) Fixed – guaranteed rate of return established at purchase
- 2) Variable – rate of future returns depends on performance of stock market
- 3) Indexed – a ratchet annuity where returns are linked to a specific index. I.e. S&P 500.

### Fixed Annuity

Pays a guaranteed amount each month for the life of the contract. The contract could be 5 years, 10 years, 20 years or even for a life time. The longer the contract, the less each monthly period. With a fixed rate it becomes easier to compare products. Fixed annuities have no market risk, but also usually have the lowest rates of returns over the long term. Plus they offer no protection against inflation and lack FDIC protection.

### Variable Annuity

Allows the purchaser to take on market risk in exchange for potentially higher payouts. Investments are made into sub-accounts which function similar to mutual funds. Variable annuities usually have no limits to what can be earned or lost. Volatility and limitation of sub-accounts are major consideration of variable annuities. Volatility in that the sub-accounts follow stock market movements and many variable annuities have limited sub-accounts choices. Fees will usually be higher than a fixed because of the added fees associated with the sub-accounts.

### Index Annuity

Has returns that are linked to a market index like the S&P 500, the Lipper Index, Lehman bond index etc. Indexed annuities usually have minimum interest rate guarantees. This minimum can range from zero to one percent meaning the value will not decrease in a down market. An Indexed Annuity will have a market cap meaning the return will be limited to a set maximum regardless of the performance of the underlying index. This class of annuities must be studied carefully to ensure you understand all the details of the index tracked and participation rates.

### Riders

Annuities may have riders that are used to customize the contract for individual preferences. Additional riders will add to the fees and to the cost of the annuity. As you can see in the following example, the cost of riders can add up quickly. Examples of riders would include:

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- Guaranteed Death 15-35 basis points\*
- Guaranteed Earnings 10-40 basis points
- Guaranteed Min Income 50-75 basis points
- Guaranteed Min Withdrawal 40-65 basis points
- Guaranteed Lifetime W/D 50-60 basis points
- Guaranteed Min Accumulation 25-75 basis points

\* A basis point is percentage. 35 basis points represent 0.35%. 35 basis points of \$1,000 would be \$3.50.

## Annuity Questions and Answers

**Will the Insurance companies keep my money after I die?** No. Contracts can be written to guarantee payments for a specific period, for a lifetime or for the beneficiary's lifetime. Should you pass away, you beneficiaries are guaranteed to receive everything you put in plus interest.

**Can income annuities can keep up with inflation.** No. An annuity should not be your only retirement vehicle. Build a pool of money outside of the annuity that can be tapped in the future. Some annuities have riders that will adjust payouts with inflation but will have lower initial payments.

**Annuities are sold by salespeople motivated by high commissions.** This is true of many annuities. Always question the salesperson's experience and credentials. Ask why they are recommending an annuity over competing investments. Consider all the options and whether an annuity is right for you.

### Comparing Annuity Contracts

- Financial strength
- Initial minimum premium
- Guaranteed rate of return
- Current rate of return
- Projected rate of return
- 3-5 year rate of return
- Investment options
- Sales charge
- Surrender charges/Penalties
- Other fees
- Special features

**Are annuities are only for older, retired persons?** No. An annuity can add diversification to a portfolio and with a guaranteed growth can add substantially to the value of a portfolio.

**Can I move an annuity after purchase without paying taxes?** Yes. Federal law allows you to move your annuity tax free via IRA rollovers and 1035 exchanges. However, surrender charges may apply.

**Surrender charges only benefit the insurance companies.** Not true. Surrender charges are designed to discourage premature withdrawals. Insurance companies take a long-term approach to investing the annuity assets. Premature withdrawals undercut this investment strategy. Most annuities will allow up to a 10% withdraw without a charge.

**What if I only need money for my life expectancy?** Statistically, half of us will outlive our life expectancy.

And married couples should be more concerned because there is a greater likelihood that a least one spouse will live to age 95.

**What is the difference between an annuity and a savings account?** An annuity eliminates the risk of outliving your savings. A periodic withdrawal from a bank saving account exposes you to the risk of running out of money.

**What is the difference between a qualified and non-qualified annuity?** A **qualified annuity** comply with federal tax code requirements for retirement plans and eligible for funding with pre-tax earnings. A **non-qualified** annuity is funded with after tax money.

**What about taxation of annuities?** For a qualified annuity, standard IRS IRA rules apply. For a non-qualified annuity, the earnings will grow tax deferred during the accumulation phase. Taxes on the earnings occur when the distribution phase begins.

**Will my heirs pay tax on an annuity left to them?** Yes. The beneficiaries will owe tax on the tax deferred gains acquired during the accumulation phase. May be subject to estate taxes. An estate planning attorney can help to determine if estate taxes apply.

**What if I change my mind after I sign the forms?** You have what is called a "Free Look Period". This means that after you have signed an annuity contract, you have a short period of time in which you can change your mind without penalties or fees. The salesman should point this out to you.

## Annuity Mistakes

**Mistake #1: Choosing an annuity provider based solely on rates.** Competitive rates are important, but equally so is the financial health of the insurance company. Choose a company with the highest financial rating from an independent rating agency.

**Mistake #2: Buying an annuity you don't understand.** Some annuity contracts offer simple, straightforward guarantees and methods of crediting interest. Others are so complicated they are confusing to financial professionals. If you can't easily understand the features and benefits, you may want to choose another provider.

**Mistake#3: Believing you are stuck with a bad annuity.** An annuity can be exchanged from one annuity to another without incurring taxes. Before moving however, check for surrender fees. It may pay to wait until the surrender period is over before exchanging an annuity.

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