Annuities for Retirement Income

Why seniors choose them, and what prospective annuity holders should consider.

Imagine an income stream you cannot outlive.
That sums up the appeal of an annuity. If you are interested in steady retirement income (and the potential to defer taxes), you might want to look at the potential offered by annuities. Before making the leap, however, you must understand how they work.

Just what is an annuity?
It is an income contract you arrange with an insurance company. You provide a lump sum or continuing contributions to fund the contract; in return, the insurer agrees to pay you a specific amount of money in the future, usually per month. If you are skittish about stocks and searching for a low-risk alternative, annuities may appear very attractive. While there are different kinds of annuities available with myriad riders and options that can be attached, the basic annuity choices are easily explained.[2]

Annuities can be either immediate or deferred.
With an immediate annuity, payments to you begin shortly after the inception of the income contract. With a deferred annuity, you make regular contributions to the annuity, which accumulate on a tax-deferred basis for a set number of years (called the accumulation phase) before the payments to you begin.[1,2]

Annuities can be fixed or variable.
Fixed annuities pay out a fixed amount on a recurring basis. With variable annuities, the payment can vary: these investments do essentially have a toe in the stock market. The insurer places some of the money that you direct into the annuity into Wall Street investments, attempting to capture some of the upside of the market, while promising to preserve your capital. Some variable annuities come with a guaranteed income benefit option: a pledge from the insurer to provide at least a certain level of income to you.[1,3]

In addition, some annuities are indexed. These annuities can be either fixed or variable; they track the performance of a stock index (often, the S&P 500), and receive a credit linked to its performance. For example, if the linked index gains 8 percent in a year, the indexed annuity may return 4 percent. Why is the return less than the actual index return? It is because the insurer usually makes you a trade-off: It promises contractually that you will get at least a minimum guaranteed return during the early years of the annuity contract.[3]

Annuities require a long-term commitment.
Insurance companies expect annuity contracts to last for decades; they have built their business models with this presumption in mind. So, if you change your mind and decide to cancel an annuity contract a few years after it begins, you may have to pay a surrender charge — in effect, a penalty. (Most insurance companies will let you withdraw 10-15 percent of the money in your annuity without penalty in an emergency.) Federal tax law also discourages you from withdrawing money from an annuity — if the withdrawal happens before you are 59½, you are looking at a 10 percent early withdrawal penalty just like the ones for traditional IRAs and workplace retirement accounts.[1,3]

Annuities can have all kinds of *bells and whistles*.
Some offer options to help you pay for long-term care. Some set the length of the annuity contract, with a provision that if you die before the contract ends, the balance remaining in your annuity will go to your estate. In fact, some annuities work like joint-and-survivor pensions: when an annuity owner dies, payments continue to his or her spouse. (Generally, the more guarantees, riders, and options you attach to an annuity, the lower your income payments may be.)[1]

Deferred annuities offer you the potential for great tax savings.
The younger you are when you arrange a deferred annuity contract, the greater the possible tax savings. A deferred annuity has the quality of a tax shelter: its earnings grow without being taxed, they are only taxable once you draw an income stream from the annuity. If you start directing money into a deferred annuity when you are relatively young, that money can potentially enjoy many years of tax-free compounding. Also, your contributions to an annuity may lower your taxable income for the year(s) in which you make them. While annuity income is regular taxable income, you may find yourself in a lower tax bracket in retirement than when you worked.[1]

Please note that annuities come with minimums and fees.
The fee to create an annuity contract is often high when compared to the fees for establishing investment accounts — sometimes as high as 5-6 percent. Annuities typically call for a minimum investment of at least $5,000; realistically, an immediate annuity demands a five- or six-figure initial investment.[3]

No investment is risk free, but an annuity does offer an intriguing investment choice for the risk averse. If you are seeking an income-producing investment that attempts to either limit or minimize risk, annuities may be worth considering.

Contact us for help in financial planning.

Citations.
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