# Annuities Explained

A 101 guide provided by Annuity.org

# Table of Contents

# Introduction

If you're worried about making your savings last throughout your entire retirement and think you may need more income than Social Security provides, you may want to consider purchasing an annuity.

With fewer and fewer workers getting pensions, annuities are filling the retirement income gap by allowing you to convert your savings into a stream of income guaranteed to last for the remainder of your lifetime. In addition, some types of annuities offer a safe place for your money to grow, allowing you to avoid the downturns that come with investing in the stock market.

Having guaranteed income alleviates the stress of trying to make your money last. It gives you peace of mind in regard to your spending because you can be confident that another check will arrive, even after your payout has exceeded your premiums. You know your bills will be covered, so you can go on with the business of enjoying your retirement.

People are often unaware of or confused about the fees associated with different types of annuities. An experienced financial consultant can help you select the right type of annuity for your particular needs and answer your questions about its features and fees. Do your research and be prepared to ask for definitions of terms you are unfamiliar with. Make sure you understand everything in the contract before you buy.

# What Is an Annuity?

An annuity is an insurance-based retirement product that can create a stream of income in retirement, somewhat like a pension. It's a contract with an insurance company for which you pay a premium — just like life or health insurance premiums — to receive regular payments over a certain time frame, potentially the rest of your life.

Receiving an annuity payout as a series of periodic payments, as opposed to withdrawing one lump sum, is referred to as annuitization. Not all annuity owners choose to annuitize their payments. Instead, they keep their money in an annuity for a lengthy accumulation, or growth, phase and eventually withdraw it as a lump sum.

As insurance products, annuities protect against the biggest risk in retirement: outliving your savings.

This insurance against living long is the mirror image of life insurance, which ensures that your dependents are financially compensated upon your death.

With an annuity, your benefit is in living longer and receiving more payments.

## How Does an Annuity Work?

Because the annuity market offers an expansive array of products, chances are good you can find a solution that meets your needs. From single premium immediate annuities to multi-year guaranteed annuities, you have choices when it comes to wealth management and financial security.

You can also pay to add various riders and other provisions to your annuity contract.

**Differences among the types of annuities include factors such as:**

- *The level of risk involved*
- *Whether you or the insurance company bears the risk*
- *Whether you will receive payments immediately or at some point in the future*

But in general, annuities are the best alternative to pensions, which are fast becoming a thing of the past. Many people have savings that are earmarked for retirement. Some or all of the money in these accounts can be turned into a steady stream of guaranteed income to supplement Social Security checks and ensure a comfortable retirement.

## Should I Buy an Annuity?

Your decision to buy an annuity will depend on whether you feel the product fits your needs. Annuity benefits include:



**Tax advantages**
Annuities grow tax-deferred, which means that any earnings or interest may accumulate tax-free until the money is withdrawn.

**Limitless contributions**
Unlike other tax-preferred retirement accounts, such as IRAs and 401(k)s, there is no limit to the amount of money you can contribute to your annuities.

**Guaranteed stream of income for life**
You can receive income payments, no matter how long you live or whether you have collected your original investment plus earnings. With a life annuity, it's not possible to outlive your savings.

**Contract provisions**
For example, you could add a long-term care rider that will give you extra money should you require such services. Or you could get a rider that permits you to designate a beneficiary or guarantee a specific payout amount, even if you die early.

**Probate-free**
Inherited annuities don't have to go through probate.

## When Should I Buy An Annuity?

Your needs and finances will determine when to buy. Keep in mind that you can't take payments from an annuity without a penalty until you reach the age of 59½. So, in that regard, you should treat an annuity as you would any other retirement vehicle.

Unlike other retirement plan options, such as IRAs and 401(k)s, however, there are no limits on the number of deposits you can make to an annuity each year. So in the event you max out the deposits to your other accounts, you can buy an annuity for additional tax-deferred retirement savings.

The sooner you buy an annuity, the more time your money will have to grow. This principle is referred to as "time horizon," and it is a key factor in deciding when — and what type of annuity — to buy.

But remember that some of the money you use to purchase an annuity will be out of reach until you start receiving your income stream. Generally, you're allowed to withdraw a portion of the money, typically about 10 percent a year.

Beyond that, many annuity contracts are subject to a "surrender period," a specified period of time after purchase during which you must pay to withdraw funds. This fee is usually a percentage of the amount you take out. Surrender periods and charges vary, with some annuities having no surrender period, so review your contract for details.

### Sample Annuity Rates

| NAME | RATE | RATING |
|---|---|---|
| MaxRate version 1 under 100k | **1.15%** | **A** |
| MaxRate version 1 100k+ | **1.30%** | **A** |
| Guarantee platinum | **2.70%** | **A-** |

**Did You Know?**

*You can get the most up-to-date annuity rates and provider ratings from our website.*

## Questions to Ask Yourself

When you're trying to figure out when to buy an annuity and which kind to buy, it's important to evaluate your own finances, goals and comfort with various levels of risk.

Before speaking with a professional, ask yourself the following questions and bring your answers to these questions with you to the meeting. This will ensure you get everything you need from your consultation.

## Annuity Suitability Questionnaire

- [ ] When do you hope to retire?
- [ ] What are your monthly expenses, including housing, food, utilities, insurance and transportation?
- [ ] How would you describe your health?
- [ ] If you had to guess, do you expect to live longer than average?
- [ ] How much do you expect to receive in monthly Social Security benefits?
- [ ] How much do you have in retirement savings? How much do you expect to have when you retire?
- [ ] Do you have a pension or any other sources of income? What is the monthly total you expect to receive from these sources?
- [ ] How much monthly income do you think you will need in addition to Social Security and any other sources of income?
- [ ] How would you describe your comfort level with investment risks?
- [ ] Do you have any dependents? If so, how much do you need to budget for them?
- [ ] What do you hope to leave to your dependents?
- [ ] What expenses do you have now that you don't expect to have in retirement?
- [ ] What expenses do you anticipate in retirement that you don't have now?
- [ ] Do you need to make a provision in case you or your spouse might need long-term care?

# Types of Annuities

Some people are intimidated by the various types of annuities and the riders, or clauses, that allow for provisions to the terms of contract.

But once you understand the concepts, it's much easier to figure out what would work best for you. The types can be broken down into two categories: immediate income and deferred growth.

## Immediate (Income) Annuities

Immediate annuities are also known as "income annuities" or "single premium immediate annuities (SPIAs)." Don't be confused by the different names. These all refer to the same thing: a type of annuity that begins payments to you within a year of purchase.

The benefit of an immediate annuity is the ability to turn a retirement savings account into a pension-like income. For example, you could use all or part of the funds from your existing retirement account to purchase an annuity and begin receiving a guaranteed stream of income.

## Deferred Annuities

People purchase deferred annuities with the intent to receive their first income payment more than a year later, either at retirement or even later in life.

This allows the money in the fund to accumulate longer on a tax-deferred basis. For example, a multi-year guaranteed annuity, or MYGA, is similar to a certificate of deposit (CD), but it pays higher interest rates and has tax advantages over CDs that are not held in IRAs or 401(k)s. MYGAs offer a guaranteed rate of return and premium protection.

With a deferred annuity, the time before you receive any payout is known as the accumulation phase. You have several choices for how that money will build during that phase.

### Fixed Annuities

Fixed annuities grow at an interest rate specified in the contract. This rate doesn't change unless the contract specifies a change. Typically, a contract will include dates at which the rate may reset.

### Variable Annuities

The growth of a variable annuity is tied to the performance of an underlying investment portfolio. The annuity purchaser can choose which investments to include in the portfolio. If the portfolio does well, the value of the annuity increases. But variable annuities also carry a risk that the investments will do poorly, and the annuity could lose money. These annuities are also more costly to the annuity purchaser.

### Indexed Annuities

Indexed annuities were commonly referred to as "equity-indexed annuities" (EIAs) until 2006 when the insurance industry began calling them "fixed-indexed annuities" to avoid any perceived connection to stocks — also known as equities. This is an important distinction because, unlike variable annuities, indexed annuities have no underlying investments. Rather, an indexed annuity's growth is linked to the performance of an outside index, such as the S&P 500 and may be limited by participation rates, interest rate caps and yield spreads.


# Monthly Income and Annual Payout Rates

As a rule, annuity income benefits are higher than other safe investments, such as certificates of deposit, but not as high as the potential gains from riskier investments, such as stocks.

The pricing of income annuities is most commonly stated as the monthly income amount or as an annual payout rate, which is simply the percentage of the premium that the annual income represents.

For example, $2,500 in yearly income is 5 percent of a $50,000 annuity, so the annual payout rate in this case is 5 percent, and the monthly income is $208.33.

**Did You Know?**

*You can get the most up-to-date annuity rates and provider ratings from* our website.

## Factors that Affect Payout and Income Benefits

Several factors can affect your payout. These include:

1. The type of annuity
2. Your age when you begin receiving payments
3. Your gender
4. Whether the annuity is shared with someone else
5. The addition of any riders
6. Any documented serious health problems
7. Market conditions at the time of purchase

## Life Expectancy, Mortality Credits and Internal Rate of Return

If you own a life annuity, which entitles you to periodic payments that cease upon your death, the longer you live, the more payments you will receive. The older you are when you start receiving payments, the fewer payments you can expect to receive, but your income benefit is higher.

And if you die sooner than expected, the remainder of your annuity funds become mortality credits.

Mortality credits, the money left over when an annuitant dies before collecting their full annuity payout, allow people who live beyond their life expectancy to receive payments from the pool of forfeited premiums.

The rate of return — not to be confused with the annual payout rate — increases with each payment you receive but is impossible to determine without knowing exactly how long you will live.

Your overall return on a $100,000 annuity that pays $833 a month, or $10,000 a year, would be 3 percent if you lived another 12 years after you purchased it. At the 10-year mark, you would break even.

Because the rate of return is directly tied to the annuitants' life expectancies — and because we have no way of knowing exactly how long they will live — we can't accurately calculate the percentage of their premium they will get back in income payments.

Some people consider this a drawback, but it's actually a defining feature of annuities. Annuities are risk transfer vehicles with tax advantages, suitable to help you meet retirement and other long-term savings objectives.

They're designed to provide spending money in retirement, and as such, they are not intended to provide the substantial returns one would expect from stocks or other securities.

| Time Period (Year) | Cash Flow |
|---:|---:|
| 0 | -$100,000.00 |
| 1 | $10,000.00 |
| 2 | $10,000.00 |
| 3 | $10,000.00 |
| 4 | $10,000.00 |
| 5 | $10,000.00 |
| 6 | $10,000.00 |
| 7 | $10,000.00 |
| 8 | $10,000.00 |
| 9 | $10,000.00 |
| 10 | $10,000.00 |
| 11 | $10,000.00 |
| 12 | $10,000.00 |
| **Internal Rate of Return** | **3%** |

# Are Annuities Taxable?

Annuities are tax deferred. This means that earnings are not taxed until money is withdrawn or paid out.

## How Are Annuities Taxed?

Annuity withdrawals are taxed as regular income by the Internal Revenue Service. If the annuity was purchased with money that had already been taxed, then the portion of the payouts and withdrawals that come from those funds will not be taxed again. If the annuity was purchased with pre-tax funds — for example, money rolled over from a 401(k) — then the entire payout and withdrawal amounts are taxable as income.



## Are Inherited Annuities Taxable?

The beneficiary of an inherited annuity is governed by the same taxation rules as the annuitant. Any funds that have been previously taxed will not be taxed when the beneficiary collects them. However, because earnings — i.e., interest paid — are tax-deferred while held in the annuity, they will be taxed as income when they are withdrawn.

# Purchasing an Annuity

Buying an annuity is an easy process. But before you make a purchase, do your research and examine what you hope to gain from the purchase.

## Step-by-Step Process for Buying an Annuity

It can't be stressed enough: Before you purchase an annuity, review your current finances and your long-term goals. Once you are clear on your objectives and how much money you can reasonably commit to a long-term savings plan, whether for retirement or another future financial goal, you're ready buy an annuity.

## Steps To Buying an Annuity

**Step 1**

Review your finances and goals. Consulting with a financial professional could be helpful at this stage. He or she can help you figure out what kind of annuity and which provisions would be best for your situation.

**Step 2**

Look at different types of annuities and what they offer. Review potential riders and contract provisions and decide what suits you best. For example, you might select a single-premium immediate annuity, with an added death benefit rider, which would allow you to transfer payments to a beneficiary upon your death.

**Step 3**

Research the annuity providers you are considering doing business with to ensure they are strong financially. You can find insurance company ratings through agencies such as Moody's and AM Best.

**Step 4**

Complete an application and provide any requested paperwork. Lock in your interest rate, according to the insurer's policies.

**Step 5**

Have the money transferred from a retirement or brokerage fund. Alternatively, you can pay with cash or check.

**Step 6**

After the purchase, you will almost certainly have what's known as a free-look period, which can be anywhere from 10 to 30 days, or perhaps longer. The length of time should be spelled out in your contract. If, during that period, you change your mind for any reason, you can back out of the contract with no financial repercussions.

*If you need assistance with any of these steps, your financial advisor can walk you through the process.*

## How Do I Choose?

Choosing which annuity will best help you achieve your goals is a matter of determining those goals and then shopping around and doing research.

If your goal is to pay your expenses in retirement and not run out of money, you want an income annuity or an annuity with an income rider. If you're concerned about keeping up with inflation, investigate the option of adding an inflation rider or, perhaps, purchase an indexed annuity, which has more potential for growth.

## Best Annuity Companies

Because annuities are sold by insurance companies, they're not backed by the Federal Deposit Insurance Corporation. Instead, they are backed by the companies that sell them and by state guaranty associations.

Check the company's ratings from agencies such as AM Best, Moody's, Fitch and S&P to ensure that you're buying from a financially sound provider.

Our partners work with the top companies in the industry.

**These companies include:**

ATHENE

AMERICAN NATIONAL

North American Company for Life and Health Insurance

AMERICAN EQUITY Investment Life Insurance Company

United of Omaha Life Insurance Company A Mutual of Omaha Company

Transamerica Financial Advisors, Inc

Oxford Life Insurance Company

Reliance Standard Life Insurance Company

National Western Life Insurance Company

Liberty Bankers Life Insurance Company

Nationwide

# Frequently Asked Questions When Buying An Annuity

You may not be retired yet, but planning for this milestone now can mean the difference between uncomfortable financial adjustments in your later years and a sustainable standard of living that allows you to make the most of this rewarding chapter of your life.

### How can annuities help with retirement planning?

Annuities can help with retirement planning in a number of ways depending on your individual needs and objectives. Due to the changing nature of retirement, people today are largely on their own to save and provide for their retirement.

When you retire, your regular income stops, and you become more reliant on your retirement savings for income. As a result, annuities take on a prominent role in providing financial security for millions of retirees. Annuities can help people who want to grow their money, protect their savings from a market loss, secure a guaranteed interest rate or generate consistent retirement income.

### What do most people hope to get from an annuity?

Annuities help people during an important time in their lives and are appealing for many reasons. Although everyone's situation is different, many people are concerned about protecting their savings or running out of money in retirement. Therefore, most of our customers buy annuities to reduce risk, generate lifetime income, achieve peace of mind and secure a better retirement.

Studies also indicate that retirees who own annuities are happier than those who do not.

### What are the most popular annuity features and types of annuities?

There are many types of annuities from which to choose, and each is designed for a specific purpose. We have an annuity solution for just about anyone needing help during retirement.

Fixed indexed annuities (FIAs) combine the growth potential of index-linked interest, the protection from market downturns and the guarantees of lifetime income. Multi-year guaranteed annuities (MYGAs) offer a stated interest rate for a set period of time. And income annuities provide the reliability and predictability of guaranteed income.

In addition, annuities receive special tax treatment, similar to that of a 401(k). Any earnings inside of an annuity will grow tax-deferred, which gives our customers a lot more control over their taxes in retirement. We recommend speaking with a tax professional to see if you could benefit from this type of strategy.

### How can annuities help in uncertain economic times?

The variability and uncertainty of market returns is a significant risk for retirees who are using their retirement savings for income. Annuities can give you confidence to weather the storm during uncertain economic times.

Many annuities offer principal protection, meaning you will not lose money during a down market, while also allowing you to participate in some of the market upside. This is a core feature of annuities and why a lot of people at or near retirement like the safety that annuities provide. If you are willing to forego some of the upside in order to have complete protection from downside risk, an annuity might be right for you.

### How can annuities help with longevity risk?

As people age, annuities become more important. They are the only financial product that can guarantee a steady stream of lifelong income. The uncertainty of how long you will live poses an undeniable challenge during retirement, and life expectancies have gotten longer. This can lead to the financial hardship of outliving your money, which is a top concern of many retirees.

A popular and sensible retirement income strategy is to build a foundation of guaranteed lifetime income to pay for your basic living expenses throughout your retirement. There are only three sources that can provide lifetime income: Social Security, an employer pension and an individual annuity. However, employer pensions have been replaced with defined contribution plans, and Social Security by itself doesn’t provide a meaningful income for many retirees. Therefore, many people are turning to annuities to create an additional stream of guaranteed income in retirement.

### Are annuities right for everyone?

There is no one-size-fits-all approach to annuities. Before you determine whether an annuity is a good fit for your situation, we encourage you to assess your own retirement goals and speak with a financial professional. There are a lot of different products and options available. A financial professional will be able to address your questions and help you determine the right annuity for your specific needs.

### What’s new in annuities?

Annuities continue to evolve and improve to meet the demands of the modern retiree and bring more value to the marketplace. We’ve seen a lot of developments with fixed indexed annuities (FIAs). The latest product innovations include enhancements that deliver more consistent returns in various market conditions and nursing home riders, which offer additional benefits if the need for long-term care is imminent.

# Hypothetical Monthly Annuity Payment Amounts

Monthly annuity payment amounts vary based on the type of annuity purchased, the current rates, additional riders and the premium amount.

Other factors that determine income benefits include the accumulation period, your life expectancy and mortility credits.

Below is an example scenario using figures from Nov. 14, 2019.

John is 65 years old and nearing retirement. His projected monthly expenses during retirement are $1,000 higher than his retirement income, even when taking into account his Social Security benefits. To fill that spending gap, John decides to purchase a single premium immediate annuity using $200,000 from his individual retirement account, or IRA.

John selects a single life only option, which will provide him with $1,047.29 every month for the rest of his life. And he’ll receive his first payment as soon as one month after purchasing the annuity.

# Glossary / Appendix

Some of the annuity terminology may be unfamiliar to people who haven't taken a deep dive into the products. If you need clarification on the language of your annuity contract, ask your financial professional, and never sign a document you don't fully understand.

**Annual payout rate** – The annual payout rate is the percentage of the premium that the annual income represents. It is calculated by multiplying the monthly income by 12 and dividing the total by the premium amount, then multiplying that number by 100.

**Free look period** – The free look period is a period of time, typically between 10 and 30 days, at the beginning of an annuity contract during which you may cancel the contract for a full refund without penalty

**Mortality credits** – Mortality credits are created from the remainders of annuity premiums after the death of annuitants who die sooner than expected. This money is distributed to annuity holders who have lived beyond their life expectancy.

**QLAC** – A qualified longevity annuity contract, or QLAC, is a deferred annuity held inside a tax-preferred retirement account.

**Rate of return** – Also called the internal rate of return, the rate of return on an annuity is the percentage of the premium that you get back in payments. It is nearly impossible to calculate the rate of return on annuities because in order to do so, one would need to know exactly how long the annuitant is going to live.

**Rider** – A rider is a provision, or enhancement, you can purchase to add a benefit to your annuity contract that is not already included.

**SPIA** – A single premium immediate annuity, or SPIA, is an income annuity purchased with a lump sum that begins paying the annuity holder income immediately.

Now that you know all about annuities, are you ready to discuss your options with one of our financial advisors? Learn how to secure your guaranteed income for life and get a free, no-obligation annuity quote today.

GET MY FREE QUOTE