What Are Annuities?

An annuity is a type of insurance that provides periodic payments by the insurer to the insured, either for a specified length of time, or for the remainder of the insured life.[1] Annuities can either be immediate, with payouts beginning within a year of purchase, or they can be deferred, with payments beginning at some time more than a year after purchase.[2] Annuities are an investment, and in some cases the money invested can be withdrawn, although normally with penalties.

Annuities are often used as a way of ensuring a stable income through a person's waning years because the payments are normally at regular intervals for roughly equal amounts. While the upfront cost of an annuity can be substantial, they can be a good investment.

However, as with any scenario involving a significant amount of money, there is risk of fraud and scams.

Types of Annuities

Annuities come in two major categories, immediate and deferred.[3] There are a variety of types of annuities within each of these broad categories.

Immediate Annuities

An immediate annuity is one that begins payments to the insured person within 12 months of purchase.[4] The full premium is paid at the time of purchase, and then payments are made for a set period of time, or for the rest of the purchaser's life. The period for payments is normally monthly, quarterly, or annually.

Deferred Annuities

Deferred annuities, on the other hand, are those that begin payments after 12 months from the purchase date.[5] Purchasers can either buy the annuity with a single premium payment, or they can accumulate a balance which will then be paid out over time.

Fixed Annuities

Fixed annuities pay a guaranteed rate of interest on the investment, which is determined when the annuity is purchased.[6] A fixed annuity may be a good choice because the payments will be

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[1] *A Consumer Guide for Annuity Products in New York,* p. 1. New York State Insurance Department, 2012. http://www.dfs.ny.gov/consumer/life/cli_annu_guide.pdf
[2] *Id.*
[3] *Ultimate Guide to Retirement: Annuities.* CNNMoney, 2013. http://money.cnn.com/retirement/guide/annuities_basics.moneymag/index2.htm?iid=EL
[4] *A Consumer Guide for Annuity Products in New York,* p. 2. 2012.
[5] *Id.*

predictable over time, and will be a good supplement for a senior's other income. The disadvantage of a fixed annuity, however, is that the interest rate will not rise to match inflation, so that the payout will be worth less over time. Inflation adjustment is an option that can be purchased with some annuities.

Variable Annuities

Variable annuities base payouts on the performance of an underlying investment.[7] These annuities have a set payment amount that will rise and fall with the performance of a portfolio of investments called a subaccount. If the investments are doing well, the payment amount will increase. If the investments are doing poorly, the payment amount will decrease. Variable annuities have the chance to outpace inflation, but there is also a chance that the payments will not be enough for a retiree to depend on.

Things to Watch Out For

Annuities can be fairly costly, so before buying one, consider the following.

Surrender Charges

Annuities are generally purchased in order to create a steady income stream. In some cases, the purchaser has no access to the amount they invested, but in others, they can withdraw funds. Normally, any withdrawal that is not a scheduled payment will result in a surrender charge that either reduces the amount to be paid over time, or reduces the amount of your current withdrawal.

Surrender charges can vary in rate, though seven percent is typical.[8] Surrender charges often only apply in the early years of an annuity. It is important to pay attention to the terms involving a surrender charge. A surrender charge above 14% is rather high, and may indicate that a company is willing to take advantage of a purchaser.[9]

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[6] *Ultimate Guide to Retirement: Annuities,* CNNMoney. 2013. http://money.cnn.com/retirement/guide/annuities_fixed.moneymag/index.htm?iid=EL

[7] *Id.*

[8] *Id.*

[9] Bigelow, Kevin. *TOL Workbook for Financial Exploitation Mini-Module: Living Trust and Annuities Scams,* p.6. San Diego State University. Accessed 2013. http://theacademy.sdsu.edu/programs/Project_Master/handouts/Living%20Trust%20and%20Annuities%20Scams-FINAL.pdf

Taxes

Annuities are generally taxed on any gains made above the original investment when funds are withdrawn.[10] In the case of fixed annuities, this is based on a purchaser's life-expectancy as listed by the IRS, as well as their initial investment. Here is an example:

> Say … you invest $100,000 in an immediate annuity and the annual payouts are $8,000. If the IRS considers your life expectancy to be 20 years, divide $100,000 by 20 to determine how much of each payout will be a tax-free return of investment. In this case, $5,000 of each $8,000 payout would be tax-free and $3,000 would be taxed at ordinary income-tax rates.

Source: Lankford, Kimberly, "How Annuities are Taxed," *Kiplinger*. 2009.

In the case of deferred variable annuities, the principle balance that a purchaser invested can make significant gains based on the performance of the underlying investments. In such a case, if the balance is withdrawn, rather than turned into periodic payments, gains are taxed at ordinary income rates.[11] The following is an example of taxes on a deferred variable annuity.

> Say, for example, that you invest $25,000 in a deferred annuity and the investments increase in value by $20,000, making the account worth $45,000. The first $20,000 you withdraw is considered to be taxable earnings, so you'll pay taxes on all of the withdrawals up to that level before you can withdraw the original $25,000 investment without taxes.

Source: Lankford, Kimberly, "How Annuities are Taxed," *Kiplinger*. 2009.

In addition to a surrender charge for early withdrawal, a 10% tax penalty is imposed if a purchaser withdraws money from an annuity before age 59 ½.[12]

Things that affect how an annuity is taxed are a purchaser's life expectancy, the type of annuity purchased, and what funds are used to purchase the annuity. The important thing to note is that gains on annuity investments are not taxed until money is withdrawn, and then those gains are taxed at income rates. For further information see the resources section below or contact a tax advisor or an attorney.

Scams

As is the case with any financial instrument, annuities can attract dishonest sellers who will try to take advantage of you. Watch out for the following warning signs that may indicate that the annuity you are being sold is a scam:[13]

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[10] Lankford, Kimberly, *How Annuities are Taxed*, *Kiplinger*. 2009. http://www.kiplinger.com/article/insurance/T003-C001-S001-how-annuities-are-taxed.html

[11] *Ultimate Guide to Retirement: Annuities.* CNNMoney. 2013. http://money.cnn.com/retirement/guide/annuities_variable.moneymag/index3.htm?iid=EL

[12] *Id.* http://money.cnn.com/retirement/guide/annuities_basics.moneymag/index9.htm?iid=EL

- **The purchaser is unlikely to live to collect a reasonable amount.** If a purchaser is in poor health, or whose life-expectancy is short, paying the substantial amount to purchase a annuity is not a good idea because it is unlikely that they will receive a significant amount of the period payments. Be wary of a seller who urges you to buy if you do not expect to live more than another 5 years after payments would begin.

- **An annuity, or multiple annuities, make up more than 35% of a person's assets, not including their home.** A annuity is supposed to provide a supplemental income, and cannot be relied on for all expenses. Predatory salespeople may try to have you spend more than is appropriate.

- **The surrender charge is more than 14%.** Especially high surrender charges may be in place to discourage any withdrawal of funds from an annuity. This may be done because insurance salesmen make commissions on the principle fund, and cancellation or withdrawal can lower than commission.

- **The same agent or agency tries to sell multiple annuities to a single purchaser.** A single annuity is a sizable investment, and while it may sometime be appropriate to own multiple annuities, they should not be from the same insurance agency.

Remember that any investment involves some amount of risk. Even fixed annuities can only be guaranteed as long as the insurer is in business and able to pay. Seek advice from trusted family members, financial advisors, or an attorney before purchasing an annuity. For helpful links, see the resources section below.

Resources

Answers: Annuities, U.S. Securities and Exchange Commission. 2011.
http://www.sec.gov/answers/annuity.htm
- A brief description from the SEC, with links to more detailed resources.

Ultimate Guide to Retirement: Annuities, CNNMoney. 2013.
http://money.cnn.com/retirement/guide/Annuities/?iid=EL
- This guide goes more in depth into various aspects of annuities.

How Annuities are Taxed, Kimberly Lankford. 2009.
http://www.kiplinger.com/article/insurance/T003-C001-S001-how-annuities-are-taxed.html

[13] Bigelow, Kevin. *TOL Workbook for Financial Exploitation Mini-Module: Living Trust and Annuities Scams,* p.5. San Diego State University. Accessed 2013.
http://theacademy.sdsu.edu/programs/Project_Master/handouts/Living%20Trust%20and%20Annuities%20Scams-FINAL.pdf

- A good article that discusses how different annuities are taxed.