



## Retirement Planning Options: Annuities

Everyone wants a golden retirement. But saving for retirement is no easy task. The baby boomer generation is graying. More and more people are approaching retirement age. With Social Security's assets being consumed and the number of workers that will support it shrinking, we will have to rely more on our personal savings when it's time to retire.

Today, we have a myriad of options to help each of us prepare for the golden years. Yet, without a specific plan of action, many people find themselves falling short when it is time for them to live off of their life's work.

Some of the most powerful retirement strategies are Annuities, Modified Endowment Contracts and the Roth IRA. This article discusses annuities.

Take the time to review your options, and ensure that you're prepared when it's your turn to retire.

### Annuities

Annuities are flexible insurance contracts designed to provide income and help you achieve long-term savings goals. And these are not unused financial vehicles: last year alone, annuity sales topped \$200 billion.

Much like a CD is a contract between you and a bank, an annuity is a long-term contract between you and an insurance company. In essence, the same company that insures your home or protects your family may also help you save for retirement.

After making a single lump-sum premium payment, or a series of periodic payments, individuals can then receive regular annuity payments from the insurance company. These payments can be made over a definite period of time, or they can last a lifetime.

Payments to the annuity owner can also be tailored to begin after the contract has been established for a number of years, or they can begin immediately after the first premium payment is made.

Annuity owners even have the choice of receiving regular fixed interest rates (better known as a "fixed" annuity), or having their annuities grow depending on the growth of underlying variable accounts (referred to as a "variable" annuity). Over time, insurance companies modified and enhanced both types of annuities; however, their basic premise has always remained the same. And because annuities are issued by an insurance company, Congress allows them to grow tax-deferred under current tax laws.

**A Myriad of Options.** Tax-deferral is not the only reason why annuities have mushroomed in popularity. While they typically have maturity dates of 5-7 years, annuities require no medical exams, and can usually be opened by filling out a basic annuity contract.

Today, there are hundreds of annuities to choose from, designed for different retirement goals. When it comes to fixed annuities, insurance companies sometimes offer higher initial rates to attract would-be buyers, while other companies promise consistent interest rates throughout the life of the annuity contract. Rates, maturity periods, and death benefits are just some of the options to look for in a fixed annuity.

Modern variable annuities also give you the option of directing how your money should be invested in separate accounts. These accounts are offered by some of the most respected money managers in the industry. Many mutual fund companies will also offer variable accounts that closely mirror their mutual funds in terms of performance, holdings and risk.

During the late 1980's, insurance companies began bundling more of these segregated accounts inside their variable annuity products. To remain competitive and increase brand awareness, well-known money managers began offering even more variable annuity accounts, in addition to their existing mutual funds.

You can find many of the most popular money managers in today's variable annuity. When you own a variable annuity, you can tell the insurer which underlying accounts you would like to use. The value of the annuity contract will then vary depending on the performance of the separate accounts you chose.

These variable accounts may rise or fall in value. However, with variable annuities, you can invest in a number of different options without additional costs or transaction fees. Plus, many insurance companies will offer a death benefit that will never be lower than the amount you originally invested.

With today's variable annuity, you can tailor your retirement account to meet your own individual needs.

**Annuity Flexibility.** Annuities are one of the most flexible savings vehicles today. You can use after-tax money to deposit into an annuity, or you can fund your annuity by rolling-over qualified money.

For example, traditional IRA and 401(k) owners can transfer their accounts into a qualified annuity, which maintains their tax-preferred status. In some cases, annuities will offer fixed interest rates, added death benefits, or other features from the insurance company that are not available in a qualified retirement plan.

Non-qualified (or "after-tax") annuities are just as popular. Because no rollover from another account is involved, non-qualified annuities often require less time to establish. In addition, when you withdraw funds, you'll only pay taxes on your accrued interest, since your principal was already taxed once before (when you earned it).

Up until this point, we've focused primarily on options available during the accumulation phase. But what about the payout phase, when the annuity returns its value to you? Fortunately, annuities can also provide incredible flexibility during the payout phase, as well.

When the payout phase begins, you can opt to receive your annuity's value in one lump-sum, or you can elect to receive a steady stream of payments in regular intervals (e.g. monthly, quarterly, etc.).

If you decide to opt for a regular stream of payments, many insurers will allow you to have annuity payments last for a set amount of time (such as 10 or 20 years). Many contracts also allow you to receive payments for as long as you and your spouse live.

For many annuity owners, having indefinite payments for the rest of your life provides a predictable source of income. Some variable annuities will even let you choose between fixed payments, or payments that fluctuate based on the performance of mutual fund investment options.

As a rule of thumb, the longer your payment period, the smaller your payments will be. These conditions are clearly spelled out in the terms of the annuity.

Want more flexibility? Some annuities are designed to be immediate annuities. Immediate annuities have no accumulation phase whatsoever. They begin paying you in regular increments the moment you purchase the contract.

**Choices to Consider.** When shopping for an annuity, there are several considerations that must be weighed.

- **Fixed vs. Variable.** Fixed annuity owners appreciate stability. Owners of fixed contracts know exactly how much their contract is earning, and when interest will be credited. Fixed annuities

offer assurances that you just cannot find anywhere else.

However, for those that believe they can "do one better" than the insurance company's interest rate, then a variable annuity may be an option. Variable annuities allow you to enjoy the upside of the market. Plus, some insurers minimize downside risk by guaranteeing that your annuity value will not decrease below your initial premium.

Some annuities are also designed to mimic the performance of the market, such as the S&P 500. These so-called "indexed annuities" provide an easy way to track performance, since market figures are readily available via the press.

- **Immediate vs. Deferred Income.** When it comes time to withdraw your money out of an annuity, you have a variety of payment options to choose from. The insurance company can pay you either in a lump sum, make periodic payments, or guarantee you a lifetime of income on a tax-advantaged basis. Depending on the annuity contract you purchase, the choice is yours.
- **Qualified vs. Non-Qualified.** Annuities can accommodate qualified or non-qualified money. For instance, suppose you are switching jobs and need to move over a 401(k). However, you already have an IRA and are looking to diversify your portfolio. You can reduce your portfolio exposure by rolling into an annuity, and not be forced to lose your money's tax advantages.

In another scenario, suppose you receive an inheritance of \$20,000. If you don't need the money right away and want to build a long-term nest egg, consider putting the inheritance into an annuity. You'll gain the advantage of tax-deferral. Plus, when it comes time to withdraw from your non-qualified annuity, you'll only be taxed on the accumulated interest, not the principal itself.

**Insurance Company.** The quality of the insurance company is important, especially when purchasing a fixed annuity. Working with a respected, highly-rated insurer can help eliminate default risk, and ensure a retirement income when you need it most.

Variable annuities, unlike fixed annuities, are not commingled in the insurer's general fund. The separate accounts inside a variable annuity provide an extra hedge of protection should the insurance company run into problems. Nevertheless, the quality of the insurer is vital, especially if your variable annuity has any additional death benefits or rate guarantees.

**Common Benefits.** All annuities, fixed or variable, share several common benefits. Here's a summary of what annuities can bring to your retirement portfolio:

- **Ideal for Estate Planning:** Proceeds from annuities pass directly to your beneficiaries without the delay, expense, and publicity of probate in most states. If you've ever had a loved one's estate go through this time-consuming legal process, you know just what kind of advantage this is.
- **The Power of Tax Deferral:** Because you do not pay taxes on earnings every year, your annuity is able to work harder thanks to tax-deferral. You will have to pay taxes on earnings when you withdraw your annuity's gains, but at least you can decide when that happens.
- **No Contribution Limits:** Contributions to other retirement savings vehicles, like 401(k)s and Individual Retirement Accounts, are strictly limited. Annuities, however, offer tremendous flexibility. You can contribute as much as you want, up to the limits imposed by the insurer, to

take advantage of tax-deferral or variable accounts inside the annuity. Plus, you can add to your annuity contract at any time.

- **Flexible Payment Options:** Unlike 401(k)s and IRAs, which require that you begin making withdrawals at age 70 1/2, you may be able to wait much longer with annuities. When you do decide to begin receiving payments, you can usually select one of the following methods:
  - Lump Sum distribution (a one-time payment)
  - Periodic distributions (you can take money only when you need it)
  - Systematic distributions (a fixed or variable amount is sent to you at regular intervals)
  - Annuitization (fixed or variable payments, guaranteed for the rest of your life)
- **Tax Control:** The money inside your annuity is made up of two components -- principal and earnings. Assuming your annuity was opened with after-tax dollars, you're only taxed on your earnings.

Different distribution methods behave differently when it comes to taxes; for instance, Lump Sum, Periodic, and Systematic distributions exhaust all earnings (which are taxable) before tapping principal. Under annuitization, each payment consists of both principal and interest, spreading your tax liability evenly among payments. Through these distribution options, you have complete control over when you will pay taxes on your earnings.

Annuities are not perfect when it comes to tax control. If you should pass away while your annuity is accumulating, all deferred taxes on your growth will become due, reducing your annuity's value.

- **Easy To Start and Maintain:** Usually, a simple application, a check, and your signature begins your annuity. And, at the end of each year, you will not receive a 1099 for income earned within your annuity contract. That's one less thing to worry about when April 15th rolls around.
- **Other Features:** Annuities also do not offset Social Security benefits like bond, CD, and other investment income does.

Annuities are easy to establish and often come with a "free look period." Your state of residence or the annuity contract will define a length of time (usually 30 days) where you can cancel your contract if you decide it's not right for you.

You can even exchange older, non-performing annuities into a newer fixed or variable annuity with no tax consequences, thanks to Section 1035 of the Internal Revenue Code.

If you are a conservative investor looking for a consistent way to build your retirement savings, then fixed annuities may be the answer for you. However, if you are financially savvy and believe you can do better choosing your annuity's direction, variable annuities offer you much greater flexibility and control.