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Understanding Fixed Annuities

Fixed Annuities

What is a fixed annuity?

Interest rate and principal guaranteed

A fixed annuity is an annuity wherein the issuer (usually an insurance company) guarantees both the interest rate paid on invested dollars and the return of principal. The issuer guarantees that a minimum rate of interest will be paid on the annuity, but the actual rate of interest credited to the annuity is typically higher than the guaranteed rate. All of the premium payments that you make to the issuer will then compound (tax deferred) at least at this guaranteed rate of return, subject to the claims-paying ability of the annuity issuer.

Distribution payouts are fixed

The second part of a fixed annuity that is "fixed" is the amount of benefit that will eventually be paid out to you during the distribution period (provided you elect to annuitize the annuity). Once the distribution period begins and you select your settlement option, the annuity distribution to you will be the same each month (or other time period that you select).

Offers a guaranteed minimum interest rate

The issuer of a fixed annuity guarantees that a minimum rate of interest will be paid for the life of the annuity. However, the annuity issuer will usually pay a higher rate of interest than the minimum guaranteed rate. The annuity issuer will typically pay a higher rate of interest on the annuity during the first year to induce people to purchase the annuity. The issuer will then usually adjust the interest rate in the following years to correspond with the ups and downs of the interest rate environment. When interest rates rise on other money market instruments or certificates of deposit, the annuity issuer will likewise increase or decrease the interest rate it pays on the annuity. However, the issuer cannot pay less than the guaranteed minimum rate without being in default.

Interest rates may be low on fixed annuities

Interest rates paid on fixed annuities are subject to the current interest rate environment. During periods of low interest rates (some periods can go on for many years), the interest rates for an annuity can be low and remain low for quite some time. Low interest rates could impact the potential growth of your annuity. However low the interest rate environment goes, the annuity cannot pay less than its guaranteed minimum rate.

When should you buy a fixed annuity?

Want to save money tax deferred

A fixed annuity may be an excellent vehicle for individuals who want the benefits of tax-deferred earnings. The earnings on a fixed annuity (as with other types of annuities) are not subject to income tax until they are distributed. Thus, your annuity premiums and earnings may compound tax deferred for many years.

Example(s): *John purchases a fixed annuity from an insurance company with a guaranteed interest rate of 4 percent. For the first year, the insurance company pays interest of 6.5 percent on the annuity. John plans to hold this annuity for 20 years. All of the interest that accrues on this annuity will be tax deferred. John will not have to pay any taxes on the interest until he begins to withdraw money from the annuity. By that time, John may be in a lower income tax bracket. (This example is for illustration purposes only and does not reflect a particular investment or product).*

Want a guaranteed fixed rate of interest on investments

A fixed annuity may also be a good investment for an individual who is a conservative investor. Because the annuity issuer promises to pay you a minimum rate of interest on the money invested in the annuity, there is little downside risk to a fixed annuity. With a fixed annuity, you know right at the beginning the minimum rate of return you may earn on your fixed annuity. Usually, the annuity issuer will pay a higher rate of interest than the minimum rate, but it will never pay less than the guaranteed amount. A risk you run with a fixed annuity is if the issuer has financial problems and becomes insolvent. In this case, it may not be able to continue to credit interest to your annuity or return the money you have invested in the annuity. Historically, there have been very few defaults on annuity contracts by insurance companies and other annuity issuers. Therefore, if you have a conservative investment outlook, buying a fixed annuity may be a good choice.

Caution: *Guarantees are subject to the claims-paying ability of the annuity issuer.*

Fixed annuity may be good supplement to qualified retirement plan

You may also want to purchase a fixed annuity if you would like to put more money toward your retirement than what you have already contributed to your qualified retirement plans . If you are saving for your retirement, most financial advisors recommend that you first contribute as much as possible to any qualified retirement plans for which you are eligible. Thus, if your employer offers a 401(k) or other type of qualified retirement plan, you should contribute the maximum amount to that plan. Unlike the purchase of an annuity, contributions to a qualified retirement plan may be tax deductible. However, if you have contributed the maximum amount to your qualified retirement plans and would still like to save more money for your retirement, then an annuity may be an excellent way to invest money whereby the earnings will be tax deferred.

Annuities are investments for individuals with long investment time horizon

Annuities tend to be good investments only for individuals who are investing money for the long term. One of the tradeoffs to the purchase of an annuity is that the insurance company will usually let you withdraw in the early years only a small percentage (10 percent, usually) of the money you have invested in the annuity without a penalty. If you want to withdraw more than this percentage each year, the annuity issuer will typically charge you a surrender charge. The surrender charge in the early years of the annuity may be as high as 5-10 percent of the amount you withdraw. The surrender penalty will then decline to zero after 5-10 years. (Basically, the annuity issuer does not want you to withdraw any of the invested money in the early years.) Furthermore, any distributions made before the annuity starting date (i.e., cash withdrawals, dividends, etc.) under an annuity contract entered into after August 13, 1982 will be taxable to the extent that the cash value of the contract exceeds the net investment in the contract at the time of the distribution.

Finally, if you withdraw money before the age of 59½, the tax code tacks a penalty of 10 percent onto the withdrawal. There are some very limited exceptions to this early withdrawal penalty tax. Between the surrender charge, the potential income tax liability, and the early withdrawal penalty tax, a substantial part of your investment may be eaten up if you make an early withdrawal from the annuity. Thus, an annuity is usually a good investment only for people who can afford to keep their money in the annuity for a period of 10-15 years and who will not begin withdrawals until after the age of 59½.

What are the strengths of fixed annuities?

Earnings are tax deferred

Like other types of annuities, the earnings on the money you invest in a fixed annuity are tax deferred until you begin withdrawing the money from the annuity. Thus, the interest that the annuity issuer pays on the annuity will accumulate tax free until withdrawals are made or the distribution period begins. Over a long period of time, money that grows tax free can accumulate faster than investments that are taxed each year. This can make an annuity more attractive than other traditional investment vehicles.

Issuer must pay guaranteed fixed rate of interest

Another benefit to a fixed annuity is that the annuity issuer (usually an insurance company) must pay a minimum fixed rate of interest on the annuity. With a fixed annuity, you will know before you purchase the annuity what the minimum rate of return will be. The annuity issuer typically pays a higher rate of interest than the minimum guaranteed rate but promises never to pay less than this minimum rate.

Can provide income for life

One of the unique features to a fixed annuity (as well as to other types of annuities) is that you can choose a stream of income that you cannot outlive, though choosing this option would result in lower periodic payments. If you elect to receive the annuity payout over your entire lifetime, the annuity issuer must make the annuity payments to you for as long as you live. For instance, if you begin receiving the annuity payments when you are 65 and you live until 100 years of age, then the issuer must make the payments to you for the entire 35 years. In a sense, an annuity can offer you protection against living too long. With other types of savings and investment vehicles, there is no guarantee that the money will last for as long as you live.

No limit on the amount you can invest in the annuity

Unlike qualified retirement plans such as a 401(k), or an IRA, there is no limit on how much you can invest in a fixed annuity. With most qualified retirement plans, there are limits on how much you can contribute each year. With a fixed annuity, though, you can contribute unlimited amounts of money to the annuity.

Have choice of distribution payouts

Another strength to a fixed annuity is that you have a choice of payout plans once the distribution period begins. You can elect to withdraw only the earnings on the annuity and leave the principal intact. You can withdraw all of the funds in the annuity in one lump sum. You can also elect to annuitize the annuity and receive payments over your entire remaining lifetime or over a specific period of time (five years, for example). If you select a fixed annuity payout (annuitization), then you will receive a series of fixed payments. In other words, you will know the amount of each payment when the distribution phase begins.

Caution: *Withdrawals, including annuitization, may subject the payments to income tax. Some withdrawals may also be subject to surrender charges which can reduce the amount of the withdrawal.*

Annuities typically not subject to probate

Another advantage to annuities is that if you die before the annuity distribution period begins, the proceeds in the annuity will go directly to the named beneficiary or beneficiaries and not be subject to probate. Because of the time delays and costs potentially involved in probate, it generally is advantageous not to have your assets pass to your heirs through probate.

What are the tradeoffs to fixed annuities?

Fixed rate of return may not keep up with inflation

One of the tradeoffs to purchasing a fixed annuity is that the fixed rate of return may not be sufficient to keep up with inflation. If the annuity issuer pays an interest rate that does not outpace the inflation rate over the life of the annuity, then, in real dollars, the investment will lose money.

High fees

Another disadvantage to a fixed annuity is the surrender charges and management fees you have to pay to the issuer. If you withdraw your money from the annuity in the early years, you may have to pay high "back-end" surrender charges to the annuity issuer. Furthermore, there is an implicit annual management fee that is built into the interest rate. In other words, the annuity issuer pays you a lower interest rate than might otherwise be available. The difference represents its fee for managing the annuity. The issuer may also charge an annual contract fee on the annuity.

Early withdrawal penalties

Another tradeoff to a fixed annuity is that there is a 10 percent penalty tax that generally applies to withdrawals from a fixed annuity prior to the age of 59½ (there are a few limited exceptions to the imposition of this penalty). With certain other types of tax-free investments (such as municipal bonds), there are no penalties if you pull your money out before a certain age.

Annuities not good short-term investments

Because of the substantial early surrender charges, the tax treatment of early withdrawals, and the penalty tax on withdrawals before the age of 59½, annuities are good investments only for people who can invest money for the long term. Annuities may not be good short-term investments or good investments for people who cannot tie up their money for a long period of time.

Fixed annuity only as secure as issuing company

Unlike a certificate of deposit issued by a bank or a savings account at a bank, there is no federal guarantee for the repayment of an annuity's principal and interest. You have to rely solely on the financial strength of the issuing company. If the annuity issuer runs into financial difficulty, it may not be able to fully repay the principal and interest that it has promised to you. Over the past 20 years, there have been a few instances of insurance companies defaulting on the payment of interest and principal on annuities that they have issued. For this reason, you should carefully analyze the financial strength of any company from which you buy a fixed annuity. It may be worthwhile to research the financial ratings of the various annuity issuers.

What are the tax implications of fixed annuities?

Accumulated earnings are tax deferred

A fixed annuity's earnings accumulate tax deferred. This tax deferral can be a big advantage for a fixed annuity versus other taxable fixed income investments, such as taxable bonds, certificates of deposit, savings accounts, and money market mutual funds. There is tax-deferred compounding of the money you invest in a fixed annuity. Earnings on your original investment compound tax deferred as well. Also, earnings on the interest then compound tax deferred. This tax-deferred compounding can result in greater overall accumulated funds than you would receive with a taxable investment.

Annuity payments partially a tax-free return of capital and partially taxable income

If you elect to annuitize your annuity when the distribution phase begins, then part of each payment you receive is treated as a tax-free return of capital, and part of each payment must be included in your gross taxable income. There is a ratio (called an exclusion ratio) that must be calculated to determine what part of the payment is subject to income tax and what part is not taxable. You first must calculate the amount you have invested in the annuity. Then, based on your estimated life span (taken from government tables), you must calculate how much the annuity will pay out to you over your whole life. You divide the amount you have invested in the annuity by the estimated total payout. This ratio is the amount of each payment that you may exclude from your taxable income. (Most annuity issuers will help you to calculate this exclusion ratio.) The remainder of each payment must then be included in your taxable income.

Caution: *If the annuity starting date is after December 31, 1986, then the exclusion ratio applies only to payments until the investment in the annuity has been completely recovered. After this point, the entire annuity payment must be included in your gross taxable income.*

Example(s): *John invests $100,000 in a fixed annuity contract. Based on his actuarial life span when he begins receiving annuity payments, John expects to receive $200,000 from the annuity over the course of his lifetime. John's exclusion ratio is 50 percent. If John receives $1,000 per month as an annuity payment, he could exclude $500 of this monthly payment from his taxable income and he would have to include $500 in his taxable income. Once John has recovered his $100,000 investment in the annuity (after 200 payments), the entire $1,000 monthly payment must be included in his taxable income.*

Value of annuity contract may be included in your estate

The value of a commercial annuity will be included in your gross estate if (1) any beneficiary receives an annuity or other payment by reason of surviving you under any agreement, and (2) under that same agreement, you received or had the right to receive an annuity or payment (either alone or with someone else) for your life, for any period not ascertainable without reference to your death, or for any period that does not in fact end before your death.

Because only annuities where someone receives a payment by reason of surviving you are included in your gross estate, an annuity that expires at your death (such as a single-life annuity) will not be included in your gross estate. However, any payments from your annuity that you received during your life that you still own at your death (that you didn't transfer or consume) will be included in your gross estate.

The two requirements (payment to a surviving beneficiary and your own right to payments) may be met if you die before the annuity payments have begun or if you die after you have received payments. In either case, the amount included in your gross estate will be the value of the annuity as of the date of your death.

Example(s): *John is 50 years old and had purchased an annuity five years ago. The annuity is scheduled to begin paying benefits to John when he reaches 65, but John dies when he's 60. The annuity has a value of $75,000 at the time John dies. This $75,000 must be included in John's gross taxable estate, even if the annuity is payable to a beneficiary other than John's estate (e.g., one of his children).*

Example(s): *Now assume John has reached the age where the annuitization of the annuity he purchased 20 years ago is scheduled to begin. John selects the straight life settlement option whereby he will receive $2,000 per month for the rest of his life. John dies two years later. Because the payments stop at John's death, there is nothing to include in his taxable estate. However, if John had selected a joint and survivor settlement option whereby the annuity payments would be paid out over the lives of both*

John and his spouse, then the value of the payments to John's spouse would have to be included in John's estate at his death.

Taxation of annuities is very complicated

Both the income and estate taxation of fixed annuities are extremely complicated.

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