Should You Purchase a Variable Annuity?

There are many horror stories circulating out there about variable annuities. And indeed, they aren't a great investment vehicle for everyone, as no single investment is suitable for every investor. But there are a number of cases where they can make sense. Let's review some of those.

You're retired and you fear you'll outlive your capital. In this case, a variable annuity can potentially help you. The variable annuity can help provide you with an additional source of income for your retirement needs. Additionally, some variable annuities now come with minimum income benefit riders, which can provide a guaranteed level of income payments regardless of the annuity account value. Of course, this guarantee is subject to the claims-paying ability of the issuing company. You should also know that an annual fee is also charged for this additional benefit.

You're saving for retirement but have maxed out other retirement savings vehicles. If you have maxed out your Individual Retirement Account (IRA) and 401(k) plans, and are seeking an additional source of tax-deferral, a variable annuity could make sense. However, this observation might only hold true if you are investing for the long-term and won't need the money for a number of years. Why? Because you'll only pay 15% on any long-term capital gains realized in a taxable account, while annuities distributions are taxed at ordinary federal income tax rates that range anywhere from 10-35% (additionally, there are federal income taxes and an additional 10% tax penalty for withdrawals prior to age 59 ½).

As a result, you will probably need a long-term investment or accumulation period (e.g., 10 to 20 years) for an annuity's tax-deferral benefit to exceed the benefit of the lower income tax rate on long-term capital gains in a taxable account. This of course, also depends upon the performance of the underlying annuity sub-account investments, as well as any reoccurring annuity fees and charges incurred during the accumulation period (e.g., mortality charges, administrative fees, management costs, and fees charged for various additional benefits).

You could potentially be the target of a lawsuit. Assets in life insurance policies and annuities are also creditor-protected in some states. That means they are exempt from lawsuits and creditor claims (as long as the money wasn’t invested in the variable annuity to defraud creditors). So, a person in a professional service business might consider placing a certain amount of assets in an annuity (e.g., doctors, dentists, veterinarians, lawyers, financial advisors, CPAs, and even journalists).

You own a variable universal life insurance policy that's not performing well. Typically, life insurance losses are not tax-deductible. But, if you move the money into an annuity using the correct process dictated by IRS section 1035, the losses can be used to offset the annuity's gains, as the premiums paid for the life insurance become the basis of the annuity.

Of course, you will want to consider whether you can afford to give up the death benefit before making this decision. In other words, you might not want to do a 1035 exchange if you are not in good health and are in need of the death benefits provided under the policy. Furthermore, you will also want to compare the investment-related fees and expenses as well as the investment options of the replacement annuity product and the life insurance policy prior to making any final decision.

You're actively trading in a taxable account. If you're actively trading in a taxable account, chances are you're paying short-term capital gains, which can range anywhere from 10-35%, depending on your income. But if you put that money in a variable annuity, you can switch investments up to a specified number of times for free, and for a very small fee after that.
On a closing note, it is important to keep in mind that annuities are long-term investments designed for retirement purposes. Withdrawals of taxable amounts are subject to income tax, and if taken prior to age 59½, a 10% federal tax penalty may apply. Early withdrawals may be subject to surrender charges. An investment in the securities underlying a variable annuity involves investment risk, including possible loss of principal, and the contract, when redeemed, may be worth more or less than the original investment. Variable annuities are sold by prospectus only, and investors should read the prospectus carefully before investing. Annuity guarantees are also backed by the claims-paying ability of the issuer.

Please carefully consider investment objectives, risks, charges, and expenses before investing. For this and other information about any mutual fund investment please call the funds provider to request a prospectus. Please read it carefully before you invest.