Understanding Annuities

Annuities can be an attractive form of investment for many people, especially those hoping to live well beyond retirement.

As we are using the term, an annuity is a contract, or policy, between you and a life insurance company. Unlike life insurance, the point of an annuity is not to pay a death benefit to your heirs. Instead, you pay a series of premiums or a single substantial premium to an insurance company, which it invests on your behalf. In return, the company agrees to make regular payments to you, either immediately or at a later date-for example, to cover your living expenses after you retire. You can structure these payments for a specific time period-say, 25 years-or for as long as you (or a spouse) are alive.

Fixed or Variable Annuities

There are several different types of annuities. One is a *fixed* annuity, in which the insurance company pays you a guaranteed rate of interest while you contribute to your account, plus a guaranteed regular payment when you begin distribution. By contrast, with a *variable* annuity, you invest your premium among a variety of options-mutual funds for example. The rate of return on your premium and the amount of money you receive upon distribution varies depending on how well your investments perform. Many people consider a fixed annuity a more secure form of investment because of its guaranteed rate of return and guaranteed payment amount.

Deferred and Immediate Annuities

Another important distinction is between a *deferred* and an *immediate* annuity. A deferred annuity is a long-term investment vehicle. With a deferred annuity, you add premiums into your account. Premiums can be paid regularly over a period of many years, or premiums can come from a rollover of another previous investment. Annuity premiums are quite flexible, and the amount of the premiums and the frequency of premium payments is up to you. When you are ready to withdraw the money, you may choose to receive a series of systematic payments or a single payment.

With an immediate annuity (often called a single-payment immediate annuity, or SPIA), you can pay an insurance company a single large sum in exchange for a guaranteed monthly payment for a specified period of time or for the rest of your life; such payments generally begin about a month after you pay the single premium.

Benefits

Annuities can offer a safety net-protection against the possibility that you will outlive your assets. Another benefit is that, under current lay, earnings are usually tax-deferred. With deferred annuities, earnings are not taxed until you withdraw your money. With immediate annuities, only the interest portion of the payment is considered taxable income.

Deferred annuities can also offer a death benefit. If you die before payout, your beneficiaries will generally receive all of your purchase premiums, plus the accumulated earnings.

Drawbacks

For certain investors an in certain situations, annuities can have disadvantages. For example, if you withdraw money from a deferred annuity before age 59 ½, you are subject to a 10 percent penalty, in addition to regular income taxes on any gains.

With s immediate annuity, once you pay the initial sum, you typically give up access to your money and are locked into the agreed-upon monthly payment. Also, with immediate annuities, payments may stop when you die. Make sure you discuss all the options with your agent to avoid this situation. It's important to be aware of any fees or penalties associated with annuities, some of which you pay when you purchase an annuity, others of which apply if you want to withdraw money early.

Finally, because annuities are not federally insured, be sure that the insurance company you buy an annuity from is financially sound-that you can depend on the company to stand behind it. For more information on annuities, consult the Securities and Exchange Commission's website, sec.gov.