What's the "Real" Return on a Fixed Annuity?

Annuity interest rates can often change in tandem with the rates paid on other fixed interest investments. However, whenever rates drop, the real return on annuities could potentially be higher than other interest-paying assets.

First of all, fixed deferred annuities typically promise a minimum rate of return for the term of the contract. For example, if you select an annuity that locks in current rates for five years, you will earn a competitive rate for the first five contract years. After that, you will receive no less than the minimum rate, regardless of how low market rates might possibly go.

Second, annuities are tax-deferred investments. That means the earnings on your annuity's principal will compound without you owing current taxes. Other fixed income investments, such as CDs, are taxed as interest is credited (of course, CDs are FDIC-insured for up to $100,000 per account). Even if you reinvest the interest, you have to pay income tax. This reduces the effective rate of return on your taxable fixed interest investments. Please note, however, that annuities are designed for long-term investing and ordinary federal income taxes and a 10% tax penalty could apply to withdrawals taken prior to age 59½.

Third, many annuities pay bonuses for the first year. This extra return could boost the yield over the term of the contract. However, early withdrawals from annuities could result in surrender charges that reduce the benefits of these bonuses. Please note that annuities that pay bonuses may have higher fees and charges and longer surrender periods than other annuities that do not offer a bonus.

In some cases, you can also put off taking money out of an annuity, and therefore delay paying income taxes. This could allow you to arrange your payments to coincide with time periods when you are in a lower tax bracket. Furthermore, you can sometimes postpone receiving payments from annuities for your lifetime and structure a plan to create additional funds for your heirs. In this case, your heirs will pay income taxes at their respective tax rates. You can't do that with CDs (of course, annuities and CDs are both subject to estate taxes if the owner's taxable estate exceeds $1.5 million).

As previously mentioned, annuity benefits and guarantees are based upon the claims-paying ability and financial strength of the underlying insurance company and are not government insured. Additionally, one should remember that annuity surrender charges are often based upon the time the insured has been invested in the annuity and surrender schedules vary from company to company.