

Annuities 101: Your Quick Guide

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When you think of life insurance, you probably think about how it can help protect your family if you were to pass away. But what about living longer than you expect? Will you outlive your savings?

Put simply, an annuity is a contract between you and an insurance company that allows you to contribute money in a tax-deferred account. In return, you can get regular payments as income — or you can withdraw those funds when you need them at a later date.

Many people choose annuities as a way to get guaranteed income in retirement that is tax-deferred. Let's examine the various types of annuities — and review the tax advantages, payouts and structure.

Now or Later

There are two main types of annuities: immediate and deferred. An immediate annuity starts paying income soon after the account is activated. In order to determine the payment amount, you must decide whether you want to receive the income over your lifetime or a certain number of years.

A deferred annuity starts with an accumulation phase. You contribute funds and the annuity grows tax-deferred. Then, during the payout period — which is delayed from when the annuity is first opened — you will receive a regular stream of income or a lump sum.

There are also single- and multiple-premium annuities. With a single-premium annuity, you pay a single lump sum at the start, and that sum then grows. With a multiple-premium annuity, however, you can spread out your premium payments over time.

Annuities are also categorized by risk and how they generate earnings. So, here are two additional components to consider with annuities: fixed and variable. Fixed annuities guarantee growth based on a minimum interest rate for the life of the annuity.

With that in mind, the insurance company may periodically increase or decrease the rate based on the market for a specified time period — though it would not go below the guaranteed minimum interest rate. Fixed annuities can be good for those who want to minimize risk and want a guaranteed payout.

A variable annuity, on the other hand, lets you choose one or more investment options called subaccounts, to potentially grow your funds. There is a greater possibility for growth as you can invest in stocks, bonds and mutual funds within the subaccounts. This comes with an investment risk of loss of both the principal and earnings. Additionally, you can usually choose from moderate to aggressive growth options — or a combination of these.

What Are Possible Advantages?

One reason annuities are included as a possible financial option is to provide tax advantages. The money you contribute to the annuity grows tax-deferred. Also, annuities have compound growth, meaning all funds in the account continue to earn interest — even interest on interest already paid. That sum of money grows faster when it's tax-deferred because there's more money to grow. The taxes are then paid on earnings (not the principal) during the payout period.

There are other tax advantages to annuities. There's no mandate for you to withdraw money from your annuity at a certain age — so the funds can continue to grow tax-deferred. You can also decide the amount and timing of the payments you take for tax purposes.

Income

Now, annuities offer some flexibility for payout. Often an annuity is "annuitized," which means that the annuity is converted into regular payments. This could be for a specific time period — like 10 years — or it could be paid out over your lifetime. Some annuities can also continue paying out funds to a surviving beneficiary.

Another way to get funds from an annuity is via withdrawals. These are lump-sum payments made at your discretion. Keep in mind, however, that pre-tax payments and annuity earnings are subject to income tax upon withdrawal, and withdrawing funds before the age of 59 1/2 generally incurs a 10 percent penalty tax from the Internal Revenue Service.

The payouts and recipients of the income are part of something known as the annuity structure. First, the owner enters into a contract with the insurance company for the annuity. The owner can then choose to be the recipient of the income (known as the annuitant) or they can designate someone else to receive that income. The owner can also decide if there will be someone to receive the subsequent income once the annuitant dies (known as an annuitant beneficiary).

Understanding "annuities 101" — the types, tax advantages, payouts and structure — can help you feel confident in preparing for your retirement needs. There may be many variables involved, but a good foundation of knowledge will help you make the best choice.