

info sheet Anatomy of an Annuity

As people take greater control over planning for retirement, the number of products designed to help them with that task has grown dramatically. Many mutual fund firms, insurance companies, banks, and employers offer a wide range of retirement planning tools — Individual Retirement Accounts (IRAs), 401(k) plans, 403(b) plans, and Roth IRAs, to name a few.

Another popular choice for retirement planners is the tax-deferred annuity. A tax-deferred annuity is a contract issued by an insurance company that lets you accumulate money tax-deferred, *i.e.*, without current taxation. When you're ready to draw from your annuity, you will have a number of options for receiving income. Annuities come in three flavors:

- **Fixed** – offers safety of principal and a rate of return for a set period of time guaranteed by the insurance company. When the guarantee period is over (typically after one to 10 years), the issuer offers a new rate for the next period.
- **Equity Index** – is a special type of fixed annuity in which earnings credited to the contract are based on a formula linked to an independent stock market index like the Standard & Poor's 500 Stock Index (S&P 500).*

*The S&P 500 is a commonly used measure of common stock total return performance. It is not possible to invest directly in an index.

- **Variable** – offers a selection of investment portfolios within the annuity that will fluctuate in value over time and may be worth more or less upon redemption. A variable annuity's return is based on the investment results of the underlying portfolios. Note: Most variable annuities include a fixed account in addition to the investment portfolios.

Unlike IRAs, which have an annual limit on how much you can contribute, annuities have no such restriction. In general, you can open an annuity with a contribution as high as \$2 million or as low as \$1,000. After that, you can contribute as much and as often as you want. What's more, you can invest knowing that no taxes will be due on these contributions or on any potential earnings until they are withdrawn from the account. Tax-deferral is just one of many features that may make annuities attractive to suitable retirement investors.

The power of tax deferral

Like IRAs, 401(k)s and other retirement programs, variable annuities are tax-deferred. You pay no current income taxes on any earnings, which allows your earnings to grow faster than in a comparable taxable investment. In addition, you won't have to track any dividends and capital gains or file any special IRS forms during accumulation. Withdrawals of earnings or other taxable amounts are subject to income tax and, if made prior to age 59½, may be subject to an additional 10% federal penalty tax.

Choice and flexibility

A variable annuity can provide you with greater investment flexibility. Within a single contract, you may have:

- **A fixed or stable component** - a fixed account, money market subaccount option, or both
- **A growth component** - the potential for long-term growth of your money through an array of stock and bond portfolios
- **Nontaxable transfers** - the ability to transfer assets from one investment option to another without incurring a tax liability.

Insurance features

Variable annuities carry three important insurance guarantees. The first is a **death benefit** guaranteed by the insurance company. If the contract owner should die during the accumulation period, the death benefit typically provides that the beneficiary will receive, at the very least, the full amount paid in, less any withdrawals. As long as there is a designated beneficiary, the death benefit amount can avoid the costs, delays, and publicity of probate. Death benefits vary by annuity, with some paying survivors a percentage over the paid-in amount or the highest prior contract anniversary value. Still others provide an additional payment of an annuity's total investment earnings (for example, 40%). The latest death benefits may offer several options, depending on the level of protection needed.

Variable annuities also offer a way to guarantee an **income that cannot be outlived**. As contract owner, you have the right to annuitize (that is, to convert from what is called the "accumulation period" to the "payout period"). When you need income, you can choose an option that guarantees a retirement income for the rest of your life, no matter how long you live.

Finally, an **expense guarantee** assures that the annuity's expenses cannot be increased beyond contractually stated amounts as long as the contract is in effect. For these reasons, a variable annuity can be an ideal component of your long-term retirement portfolio because it offers the potential rewards of stock and bond investing coupled with the comfort of insurance benefits.

When you retire

When you are ready to start using the money you have accumulated, you enter the payout period. Variable annuities offer a number of payout options, allowing you to select a plan that best fits your needs. There are essentially three options available to annuity owners during the payout period.

- **Lump-sum Distribution.** This is when you withdraw all of your assets at once. At that time, income taxes are due on any earnings or other taxable amounts, unless you're making a 1035 Exchange. A 1035 Exchange is a tax-free method of exchanging an existing life insurance or annuity policy for a new policy with a different company. The exchange must meet the requirements of Section 1035 of the Internal Revenue Code to be tax-free.
- **Systematic Withdrawal Plan.** This option lets you determine how much and how often to withdraw. Your income payments are based on either a specific dollar amount or a percentage of you annuity's value. Systematic withdrawals give you the flexibility to discontinue or change your payments at any time. Under this option, the money you withdraw is taken from investment earnings first and therefore taxed as ordinary income.

● **Annuitization.** By choosing to annuitize, you can structure your payout to guarantee an income for the rest of your life or for a specific number of years. Each contract contains annuity tables that demonstrate how the insurance company arrives at the initial annuity payment rate, which can vary by the age and sex of the annuitant. The options are:

- *Fixed Annuitization* - The amount of your income payments is fixed and will not fluctuate. The amount received each period depends upon the income option chosen — income for life or income for a certain number of years. While choosing fixed annuitization allows you to know how much you're receiving each month, it does not allow your money to keep pace with inflation.
- *Variable Annuitization* - The amount of your income payments (either for life or for a finite number of years) will depend on the current value of the underlying investment, which varies over time. A variable annuitization payout option gives your money the best chance of keeping up with inflation.

With non-qualified money, annuity income payments are tax-advantaged because part of each payment is considered return of principal and therefore is not taxable. Please be aware that some annuitization options are irrevocable.

Fees and charges

A variable annuity carries two types of asset-based expenses — an investment management fee and an insurance contract fee. The former may range from 0.25% to 2% per year, depending on the type of investment portfolio you choose. The latter expense also varies, but most companies charge between 1%

and 1.5%. Contract owners may also be assessed an annual contract fee of between \$30 and \$40 (in many cases, this charge is dropped once a contract reaches between \$75,000 and \$100,000).

Most variable annuities are offered without an initial sales charge. However, canceling the contract during the earlier years may trigger an early withdrawal charge (frequently called a “surrender charge”). This charge typically ranges from 5% to 9% in the first year and subsequently declines to 0%, generally after five to seven years. But remember, as long as you remain committed to accumulating money and leave your money in long enough, you will not incur a surrender charge.

Choose carefully

Before choosing an annuity, it's important to take several things into consideration: the investment selections, the historical performance of the underlying portfolios, the income options, the insurance features, fees and charges, and, perhaps most importantly of all, the soundness of the insurance company offering the annuity. In addition, you should examine your own personal circumstances by asking yourself the following questions:

- When do I want to retire?
- How much income will I need when I retire?
- What assets will I have to draw on during retirement?

After you've answered these questions, read all you can about retirement planning and then consult with an investment professional about specific choices you are considering. Only by doing your homework can you determine whether (and which) annuities should be part of your overall retirement plan.

Note: Annuities are long-term, tax-deferred investments intended for retirement planning. **Withdrawals of certain earnings or other taxable amounts are subject to income tax and, if made prior to age 59½, may be subject to an additional 10% federal tax penalty. Early withdrawals have the effect of reducing the death benefit and contract value.**

Guarantees are backed by the claims-paying ability of the issuing insurance company. Investments in the variable portfolios will fluctuate and may be worth more or less upon redemption.

Resources for further information

Morris, Virginia B. **Creating Retirement Income**, Lightbulb Press, 1998, \$14.95.

Shapiro, David and Streiff, Thomas F. **Annuities**. Dearborn Trade, 1997, 181 pages, \$29.95.

Wells, Bruce F. **All About Variable Annuities: From the Inside Out**. Irwin Professional Publishing, 1995, \$19.95.

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