Variable Annuities

Like a mutual fund wrapped in an annuity wrapper, a variable annuity is a contract between you and the insurance company which allows you to invest your funds in a wide range of investment or funding options, including stocks, bonds, money markets, and other fixed rate instruments. Most variable annuity plans offer a number of investment option sub accounts which are structured as either mutual funds or as segregated investment accounts that are managed by professional investment managers.

Like a fixed rate deferred annuity, any gains in the annuity credited to the account are tax deferred, i.e., not taxable until the funds are withdrawn. Unlike a fixed deferred annuity, your funds are not guaranteed and depending on the funding account you choose, may be subject to market risk, including risk of principal. Some variable annuity plans offer a fixed interest rate account option that guarantees both principal and interest on amounts invested in that option. Variable annuities are usually offered on a flexible premium or payment basis rather than a single premium or lump sum payment basis.

Variable annuities, like fixed deferred annuities, typically have penalties for early withdrawal called surrender charges or withdrawal charges. These charges typically decline over the length of the surrender charge period (typically five to ten years). In addition, like fixed deferred annuities, most variable annuities allow you take up to 10% of your account value each year without incurring a surrender or withdrawal charge. In addition to surrender or withdrawal charges, most variable annuities have certain loading and management fees, such as administrative fees. The issuing insurance company usually charges an administrative fee and a mortality risk fee totaling 1.00% to 2.00% of assets, with a typical fee usually about 1.25-1.50%. Many companies also charge a flat dollar amount which varies from $20.00 to $50.00 per year (a contract fee). Investments in the various sub accounts are typically subject to a fee for the operation and management of the sub account (account fees), and these fees are typically a percentage of assets ranging from .15% to 1.50% of assets under management in the account.

What are the pros and cons of variable annuities?

The advantage of a variable annuity is the ability to invest your annuity premium into equity investments such as stocks, bonds, or mutual funds and participate in the potentially higher gains available historically in the equity or bond markets. Gains in your variable annuity are tax deferred until they are actually withdrawn from the contract or annuitized. All gains in a variable annuity are taxed as ordinary income the year the money is withdrawn.

The major disadvantage of a variable annuity is that your assets, including your principal, are subject to market risk, i.e., loss in value based upon poor performance of the markets. As with a fixed deferred annuity, your investment in a variable annuity should be viewed as a means to fund your long-term retirement goals. Historically, investment in the equity markets has resulted in higher gains than fixed rate investments. Of course, many factors are important in determining whether a variable annuity is right for you, including your age, retirement goals, and aversion to risk. If you are young and looking to accumulate significant funds for your long-term retirement needs, a variable annuity is an excellent way to do so. If you are older and closer to retirement or simply desire to preserve your accumulated assets by investment in a safe vehicle, a fixed deferred annuity may be the best choice.

What is the death benefit on a variable annuity?

Most variable annuities have a death benefit which is the greater of (a) the contract value on the day of death; (b) the total premium paid into the contract, or (c) the contract value on the prior anniversary date of the contract. This is referred to as the 'Stepped-Up Death Benefit.'

How can annuities enhance my portfolio?

In a word: diversity. Any financial advisor will tell you that the more diverse your holdings, the better your assets are protected against risk. Annuities can provide varying levels of risk, depending on the type of annuity, but all annuities are equity vehicles, i.e., you own part or all of the asset (as compared to debt instruments, where you owe another entity). This is because annuities are products which you purchase, not funds in which you invest. You purchase the annuity contract from an insurance company, and that company in return pays you according to the terms of the contract.

Annuities give me a guaranteed income for life? How?

Annuities are the only investment vehicle to offer a guaranteed income for life. With every other type of savings investment, you can never be sure your income will continue for as long as you live. With an annuity, the insurance company designs the annuity around your income goals, guarantying payment for as long as you live. Most insurance companies will also offer a guaranteed income for a specific period such as five or ten years. The guaranteed lifetime income may be based on your life only, or based upon the life of both you and a joint annuitant, typically your spouse.

What's the impact of an annuity on my taxes?

If the annuity is nonqualified, i.e., purchased with after-tax dollars, only the gain or earnings are taxable. However, the taxes on the gain or earnings are deferred until such time as you actually withdraw the earnings. To the extent that there is a gain or earnings in the contract, the IRS considers any money withdrawn to be earnings. For example, let's say you deposited $10,000 in a variable deferred annuity, and five years later that deposit had accumulated to be $15,000. In this example the first $5,000 withdrawn is considered earnings by the IRS and is taxable as ordinary income in the year in which it is withdrawn. Because the IRS allows special tax-deferred treatment on annuities for the purpose of accumulating funds for retirement, any earnings withdrawn prior to age 59½ are considered a 'premature distribution' and are also subject to a 10% tax penalty in addition to ordinary income tax. If the annuity is qualified, i.e., purchased with before-tax dollars, any amounts withdrawn including principal are subject to tax in the year in which they are withdrawn. Again, any withdrawals made prior to age 59½ are considered a premature distribution and also subject to a 10% tax penalty in addition to ordinary income tax.

What advantages do annuities offer that typical investment options don't?

With the wealth of investment options available, what perks do annuities offer that typical investments don't? After all, deciding where to put your money is the most crucial decision you make, the choice that starts you down the road to financial security. How can annuities get you there better, faster, and safer than typical investment products? The answer lies in the three ways annuities stand out from the crowd: their tax deferred status, the avoidance of probate, and the promise of guaranteed income for life.

What's "probate" and why is avoiding it such a good thing?

Probate (the judicial process to establish a will's validity) can delay the passing on of sometypes of assets for significant amounts of time. Assets in an estate typically cannot be passed on to heirs until the probate court has established the validity of the will and authorized the executor to distribute them. Because probate is a judicial process, the process can take anywhere between six and twelve months to conclude, and the legal expenses can be significant. Proceeds from annuities and life insurance, on the other hand, are not subject to probate and may be passed to your designated beneficiary directly without going through probate.

Can I avoid surrender or early withdrawal charges?

Yes. With most fixed deferred annuities, the surrender or withdrawal charges are waived if you (1) die; (2) become confined to a hospital or nursing home for a specified period; or (3) choose to take a guaranteed income stream. In addition, most fixed deferred annuities allow you take up to 10% of your contract value each year without incurring a surrender or withdrawal charge.

Explain “qualified” and “nonqualified”

Qualified means the annuity is purchased using before tax dollars under one or more plans defined as qualified by the Internal Revenue Code (e.g., IRA, SEP, HR10, TSA, 401k, or other qualified pension plan). Contributions into one of the qualified plans are currently tax deductible, and taxes are payable on the full account at the time the funds are distributed. Nonqualified means the annuity is purchased using after tax dollars (i.e., taxes have already been paid on the funds invested). In other words, these are funds you have earned and already paid income tax on. These funds are allowed to accumulate on a tax deferred basis.

Can annuities fund qualified plans like IRAs?

Yes. Annuities may be purchased on either a nonqualified basis or a qualified basis.

Do I have to withdraw funds from a qualified or nonqualified annuity?

Yes for qualified, and no for nonqualified. If you have an IRA, 401k, SEP-IRA or SIMPLE Plan, you are required to begin minimum required distributions by age 70½. In the calendar year in which you reach age 70½, you must make your first withdrawal by the time you reach age 70½. In subsequent years, you must make the withdrawal by the end of each calendar year. The required minimum distribution is based upon your life expectancy or upon the joint life expectancy of you and your beneficiary. These life expectancies are set forth by the IRS. Failure to make the required minimum distribution by the time required results in a penalty equal to 50% of the amount of the required withdrawal or distribution.

Of course, ordinary income taxes are due on the entire amount of the withdrawal or distribution, as the amounts you contributed were deductible on your income tax. With a nonqualified annuity, there is no requirement to withdraw your funds at any age except as may be required by the annuity contract itself, which may force a distribution or annuitization at a certain age, typically age 100. However, many annuity contracts issued on a nonqualified basis do not require distribution of the proceeds until death. If you choose, you can leave the funds in your annuity to your beneficiary. Upon your death, the proceeds will be distributed to your beneficiary as follows: If you annuitize your contract and begin receiving an income and then die, the payments to your beneficiary must continue at the same rate or faster. If you die before you annuitize the contract, and your spouse is the beneficiary, the annuity contract may be continued with your spouse as the new owner.

No distribution of the proceeds is required. If you die before you annuitize the contract, and the beneficiary is someone other than your spouse, the beneficiary has two choices: (1) the entire value of the contract must be distributed in a lump sum within five years of your death; or (2) your beneficiary may elect to begin distribution of the proceeds within one year of the date of your death based upon his or her life expectancy or at least a minimum of five years. The proceeds of an annuity are taxed to the beneficiary in the same manner as they would be for you, i.e., the gain in the contract is considered ordinary income, but is not subject to the 10% tax penalty even if distribution occurs before the beneficiary is age 59½. Proceeds that are taken under an annuitization payout option are taxed in the same way as annuity payouts under an immediate annuity.