Guide to Annuities

Annuities are forms of financial protection. An annuity is a contract written by a life insurance company to provide continuing income, typically for retirement. Payments, which are generally made on a monthly basis, are usually arranged to continue for as long as you live or for a stated period of time. Payments may begin at once or at some future date.

The annuity contract is often described as being the opposite of life insurance. It pays while you live; life insurance pays when you die. Actually, the two can complement each other. Instead of lump sum benefit payments, many life insurance beneficiaries choose to use their policy's proceeds to purchase an annuity.

You should tailor any decision to buy an annuity to your own needs. To do so, talk with a qualified life insurance agent or financial advisor.

Why People Buy Annuities

Many people buy annuities to give them retirement income for the rest of their lives. An annuity contract can also be a means of building assets for other purposes with a more limited time span.

Annuities can be used to fund an Individual Retirement Account. They also may be used in Keogh-type retirement plans for the self employed.

Types of Annuities

There are two basic types of annuity contracts. The kind of annuity you choose to buy determines when benefit payments will begin.

Immediate annuities are generally purchased by people of retirement age. Such plans provide income payments at once or soon after purchase. They are usually purchased with a lump sum payment.

Deferred annuities are plans under which you arrange to have income payments start at some future date. Interest builds up on the money contributed. Such plans are often used by younger people to save money for retirement. These plans have become popular in good part because of the tax-deferred buildup during the accumulation period, the time during which you pay money into the annuity contract.

- If you buy a deferred annuity with a lump sum, it is known as a "single premium deferred annuity".
- You can, however, pay for your deferred annuity over a period of years. Typically, this type of contract allows flexibility in premium payments. Except for the first year, premiums may vary from year to year, with no requirement that any specified amount be paid in any given year. Such a contract, called a "flexible premium retirement annuity," can be used as an Individual Retirement Account.

Under either form of deferred annuity, if you die before the annuity payments begin, the accumulated value of your contract is paid to your designated beneficiary.

You can also convert the cash value of your life insurance policy to an annuity. For example, if you are over 65 and your children are out of school and are financially self-sufficient, you may now feel you no longer need all of your life insurance coverage. Your life insurance policy probably contains an option allowing you to convert its cash value to a life-time income.

Loans

Some contracts let you borrow against your accumulated contract value. You may also be able to use the annuity as collateral for a bank loan.

Interest

With deferred annuities, insurance companies guarantee the interest that will be credited to your contract value. Every contract contains a long-term guarantee. The company, typically, credits interest at rates higher than the guarantee, as its investment results permit, and it may provide short-term guarantees at rates higher than the long-term guaranteed rate or rates.

With an immediate annuity, you will be told at the time of purchase exactly how much money you will get and when you will get it.

How About Taxes?

When you buy a deferred annuity, the interest credited to your contract builds up free of current income tax.

Once you start to receive a monthly payment, however, the government begins to tax the accumulated interest. Part of each payment will be interest and will be taxed as ordinary income. The other part is principal and is not taxable. This is true of both deferred and immediate annuities.

If you withdraw money from your annuity before age 59 1/2, the interest you have earned on your contributions must be withdrawn before the principal and is subject to personal income tax. In addition, there is a ten percent penalty tax on such premature withdrawals, except in certain circumstances, such as disability or death.

You may want to consult a tax advisor well in advance of retirement for more information about the taxation of retirement income. Also, the Internal Revenue Service has helpful booklets on the subject.

Most states require insurance companies to pay a tax, commonly at two percent, on the annuity premiums they receive. A company will either charge you for the tax separately or include it in the premium amount.