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FCS5268

An Introduction to Annuities[1]

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An annuity contract is purchased from a life insurance company. The individual gives the insurance company a lump-sum payment or a series of payments. In return, the company will provide a stream of payments to the individual.

Although an annuity is purchased from a life insurance company, it serves a different purpose than life insurance. Below is a chart comparing life insurance to annuities.

Immediate and Deferred Annuities

Annuities are classified as immediate or deferred annuities. An annuity that is scheduled to start making payments to the investor within a year is classified as an immediate annuity. If the payments are scheduled to happen in the future (more than a year), the annuity is classified as a deferred annuity.

Deferred Annuities

The deferred annuity is an investment vehicle that can be used as part of a pre-retirement strategy to accumulate funds for retirement. A consumer would be wise to first evaluate investment options available through a retirement plan in the workplace, such as a 401(k), or an Individual Retirement Account (IRA), which can be purchased outside of the workplace. If an investor is contributing the maximum to those vehicles and is seeking additional options for tax-deferred growth, a deferred annuity may be an effective investment option. A deferred annuity should be considered a long-term investment vehicle. There are IRS penalties for withdrawing funds before 59.5 years of age. In addition, if funds are withdrawn before a date stipulated in the contract, which is generally 5–10 years from contract purchase, then the insurance company may charge a surrender fee.

Table 1. Comparison of Life Insurance and Annuities

Life Insurance	**Annuities**
Protects against loss of income resulting from death	Protects against loss of income due to outliving assets
Medical underwriting	No medical underwriting
Tax efficient death benefit	Death benefit is taxed

1. This document is FCS5268, one of a series of the Family Youth and Community Sciences Department, UF/IFAS Extension. Original publication date March 2014. Visit the EDIS website at http://edis.ifas.ufl.edu.

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Immediate Annuities

An individual purchases an immediate annuity as a way to avoid depleting all of their assets in retirement. An immediate annuity is paid using a lump-sum payment. In return, the insurance company will make regular payments to the individual. The goal is to transfer the risk of depleting the asset amount to the insurance company. The insurance company charges fees to assume this risk.

Immediate annuities have advantages and disadvantages. An immediate annuity offers the advantage of tax-deferred growth. However, they come with significant fees and surrender charges. If the asset is tapped in the early years of the contract, then large surrender charges can cause the annuity owner to lose money.

Vehicles to Provide Assets in Retirement

Individuals use a variety of products to save and invest for retirement. Retirement accounts such as IRAs are one such product. The IRA, which is not a new type of investment, is a tax-advantaged wrapper around typical investment products, such as stocks, bonds, and mutual funds.

In similar fashion, an annuity contract is not a new type of savings or investment vehicle. It is also a tax-advantaged wrapper that can be put around savings or investment vehicles with a contract guaranteed through an insurance company. The annuity vehicle can be in the form of a fixed annuity, which has similarities to savings products, or in the form of a variable annuity, which is similar to an investment product such as a mutual fund.

Fixed Annuities

A fixed annuity contract typically states that the interest rate paid to the annuity owner is fixed for a certain period of time, such as 1–10 years. After the fixed period ends, the rate will change. The new rate will depend on current economic conditions. The contract may stipulate a minimum rate that will be guaranteed by the insurance company.

Although fixed annuities do not come with the performance risk of investments, they do come with inflation risk. The payments to the consumer may not keep pace with inflation. Some contracts will provide cost-of-living adjustments. If cost-of-living adjustments are offered, it may mean lower payments in the early period of the contract and increased payments as time passes.

Immediate Fixed Annuity Settlement Options

Research has shown the purchase of an annuity will usually decrease the amount of assets left to heirs. However, payments from an immediate annuity can be structured to continue to a spouse or other dependent. These options will decrease the amount of each scheduled payment and may increase the cost of the annuity.

Straight–life will typically provide the largest possible payment for a given deposit. At the annuitant's death, payments will cease.

Joint and survivor pays until both the annuitant and the beneficiary are deceased. The dollar amounts of the payments are based on the life expectancy of both the annuitant and beneficiary. The contract can stipulate that the survivor receive a payment at 100% or less of the prior amount.

Installment-refund options provide a lifetime benefit to the annuitant. If the annuitant dies before receiving the original lump-sum amount, then the remainder in the account is paid out in installment payments to the beneficiary.

Immediate Variable Annuities

A variable annuity is an investment vehicle that provides a variety of investment sub-account options. The goal for the variable annuity owner is to have the assets in the annuity outpace inflation. This will allow the owner to maintain or increase their standard of living. The risk is that the investments may perform poorly, and the owner could lose all or some of his/her investment. In the case of an immediate variable annuity, poor investment performance can lead to lower payments; and thus, the owner would have less income. The charges, fees, and expenses of the variable annuity will be detailed in the annuity's prospectus.

Variable Annuity and Death Benefits for Beneficiaries

A variable annuity contract may stipulate a death benefit payable to the annuitant's beneficiary. A common type of death benefit provides your beneficiary with either the amount of the money in your account or the amount of money deposited minus your withdrawals.

Research the Insurance Company

Since an annuity contract is guaranteed through an insurance company, it is a good idea to check the financial stability of the company. Rating agencies, such as Standard and Poor's, A.M. Best, and Moody's, are paid by insurance companies to rate their stability. The insurance company's rating can usually be found on the rating agency's website. In addition, you can find out if an insurance company is licensed in Florida by checking with the Florida Department of Financial Services.

Some Points to Consider

Immediate fixed annuities can be used to insure a stream of income throughout life expectancy. The following factors will affect the amount of income provided by an immediate annuity: the lump-sum amount deposited with the insurance company, the annuitant's age, the interest rate paid by the company, the settlement option chosen by the contract owner, and the fees and other expenses charged by the insurance company. Immediate annuities can be considered a way to make assets last, but they are not likely to be an effective way to grow assets.

Variable annuities provide a way to grow assets and the potential for keeping pace or exceeding the rate of inflation. However, they do come with the risk of losing assets.

A consumer should compare their income needs and sources of income from Social Security and pensions. The question to ask is whether there may be a deficit. If a deficit exists, investigate the value of your other assets—such as money in savings and investment accounts. Should some of this money be annuitized? If annuitized, would you be comfortable knowing the full value of the annuity account

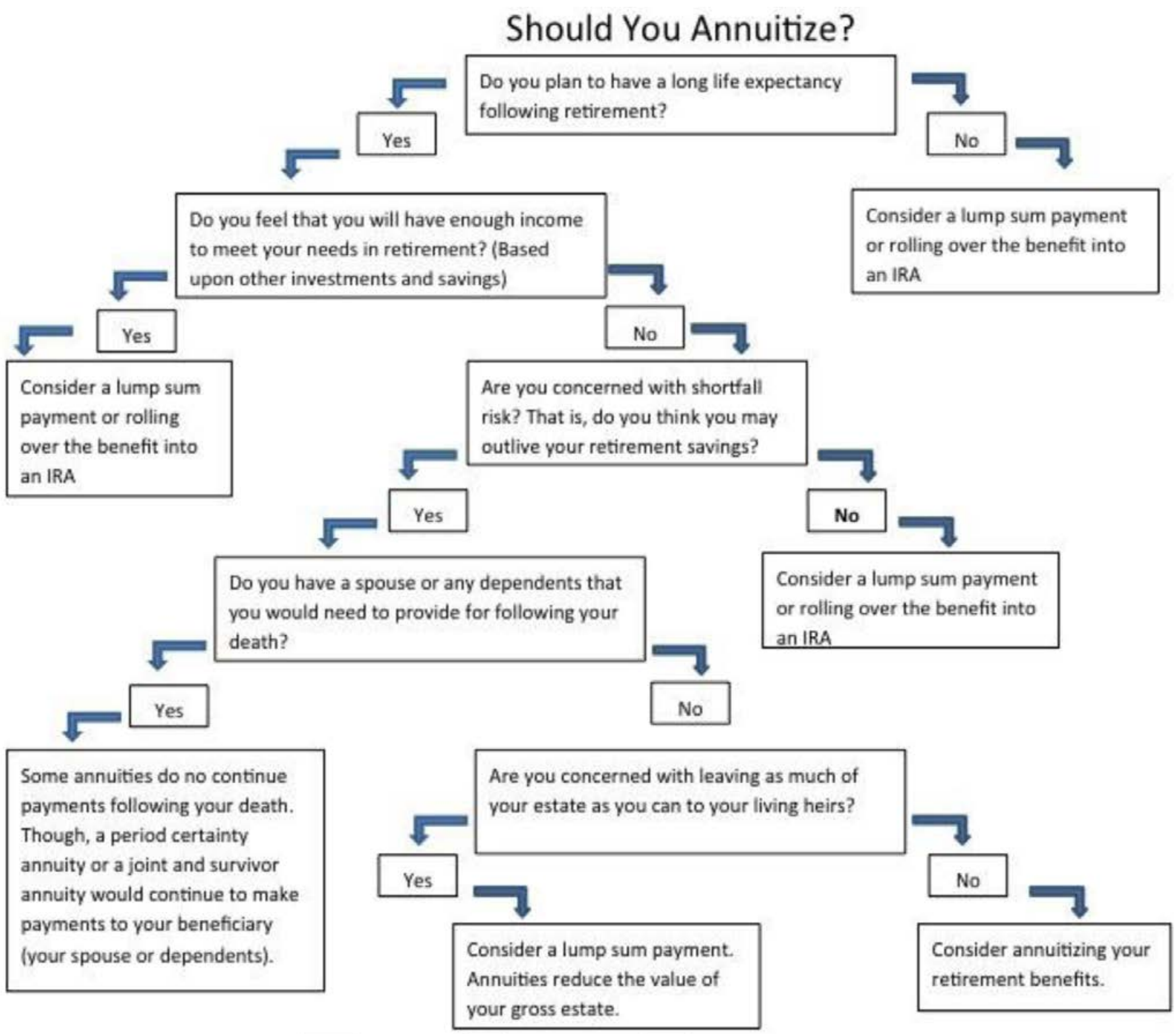

Figure 1. A guide to help you determine if you should annuitize
Credits: Michael Gutter and Brittany Stahl

will not be available? In addition, you may want to consult with a tax advisor to see how annuity payments will affect your tax rate.

The flowchart in Figure 1 may help you evaluate the appropriateness of an annuity. However, before purchasing an annuity, you may want to seek guidance from a financial professional who does not earn a commission selling annuities.

Thoughts to Help with Decision-Tree Questions

Do you plan to have a long life expectancy following retirement? This is a tricky question because it involves uncertainty. Few things are certain, so the best option is to be objective and use tools to help. One good tool is the Social Security Administration life expectancy calculator at http://www.socialsecurity.gov/OACT/population/longevity.html. The life expectancy calculation will be based on your gender and date of birth as compared to others in your cohort group. It will not take into consideration your health, lifestyle, and family history.

Do you think you will have enough income to meet your needs in retirement? In order to answer this question, you need to consider many variables such as desired lifestyle in retirement, anticipated inflation rate, anticipated return on investments, sources of retirement income, and the amount of retirement savings you have accumulated. Do not be overwhelmed by the number of variables or the need to estimate. There is a very good online tool called the BallPark E$timate http://www.choosetosave.org/ballpark that can help you do the calculation. For the replacement income input, consider your expenses now and how they will change in retirement. The publication "Retirement Need Analysis: How Much of My Current Income Will I Need for Retirement?" (http://edis.ifas.ufl.edu/fy1355) serves as a good guide. Inputs such as inflation rate and investment returns will call for estimations. This type of input will fluctuate, so use an average estimate based on what is likely to happen during a span of years. For instance, you could use an estimate of 3.5% for inflation rate.

Do you have a spouse or any dependents that you would need to provide for following your death? If yes, evaluate whether existing assets will cover their needs, and evaluate the risk of asset depletion during their lifetime. Also, consider the feasibility of other insurance options, such as term life insurance.

Are you concerned with leaving as much of your estate as you can to your heirs? Your answers to the questions above will help you measure whether you have the resources to support your lifestyle in retirement. Consider whether you are likely to deplete those assets during your lifetime. As mentioned, annuities are a way to transfer that risk to the insurance company. Consider your resources needs and comfort level with the risk of outliving assets. How does that compare with the need to transfer money to your heirs?

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