Royal Securities Company
Deborah VanderJagt
Financial Consultant
170 College Ave.
Suite 100
Holland, MI 49423
616-393-2096
dvanderjagt@royalsecurities.com
www.debvanderjagt.com

Annuities

ROYAL SECURITIES COMPANY
INVESTMENT PROFESSIONALS

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Annuities

What is an annuity?

Contract between purchaser and insurance company

An annuity is a contract between you (the purchaser or owner) and the issuer (usually an insurance company). In its simplest form, you pay money to the annuity issuer, the issuer invests the money for you, and then the issuer pays out the principal and earnings back to you or to a named beneficiary.

Two distinct phases to annuities

There are two distinct phases to the life of an annuity contract. One phase is called the accumulation (or investment) phase. This phase is the time period when you invest money in the annuity. You can invest in one lump sum (called a single payment annuity), or you can invest a series of payments in an annuity. The payments may be of equal size over a number of years (e.g., $5,000 per year for 10 years), or they may consist of a series of variable payments. The second phase to the life of an annuity contract is the distribution phase. There are two broad options for receiving distributions from an annuity contract. One option is to withdraw earnings (or earnings and principal) from an annuity contract. You can withdraw all of the money in the annuity (both the principal and the earnings) in one lump sum, or you can withdraw the money over a period of time through regular or irregular payments. With these withdrawal options, you continue to have control over the money that you have invested in an annuity. You can withdraw just earnings (interest) from the account, or you can withdraw both the principal and the earnings from the account. If you withdraw both the principal and the earnings from the annuity, there is obviously no guarantee that the funds in the annuity will last for your entire lifetime. A second broad withdrawal option is the guaranteed income (or annuitization) option.

Guaranteed income (annuitization) option

A second broad withdrawal option for an annuity is the guaranteed income option (also called the annuitization option). If you select this option, you will receive a guaranteed income stream from the annuity. The annuity issuer promises to pay you an amount of money on a periodic basis (monthly, quarterly, yearly, etc.). You can elect to receive either a fixed amount for each payment period (called a fixed annuity payout) or a variable amount for each period (called a variable annuity payout). You can receive the income stream for your entire lifetime (no matter how long you live), or you can receive the income stream for a specific time period (10 years, for example). You can also elect to receive the annuity payments over your lifetime and the lifetime of another person (called a "joint and survivor annuity"). The amount you receive for each payment period will depend on how much money you have in the annuity, how earnings are credited to your account (whether fixed or variable), and the age at which you begin the annuitization phase. The length of the distribution period will also affect how much you receive. If you are 65 years old and elect to receive annuity distributions over your entire lifetime, the amount you will receive with each payment will be less than if you had elected to receive annuity distributions over 5 years.

> **Example(s):** Over the course of 10 years, you have accumulated $300,000 in an annuity. When you reach 65 and begin your retirement, you annuitize the annuity (i.e., elect to begin receiving distributions from the annuity). You elect to receive the annuity payments over your entire lifetime--called a single life annuity. You also elect to receive a variable annuity payout whereby the annuity issuer will invest the amount of money in your annuity in a variety of investment portfolios. The amount you will then receive with each annuity payment will vary, depending in part on the performance of the mutual funds. In the alternative, you could have elected to receive payments for a specific term of years. You could have also elected to receive a fixed annuity payout whereby you would receive an equal amount with each payment.
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> **Caution:** Guarantees are subject to the claims-paying ability of the annuity issuer.

Cannot outlive payments to you if you elect to annuitize for your entire lifetime

One of the unique features to an annuity is that you cannot outlive the payments from the annuity issuer to you (assuming you elect to receive payments over your entire lifetime). If you elect to receive payments over your entire lifetime, the annuity issuer must make the payments to you no matter how long you live. Even if you begin receiving payments when you are 65 years old and then live to 100, the annuity issuer must make the payments to you for your entire lifetime. The downside to this ability to receive payments for your entire life is that if you die after receiving just one payment, no more payments will be made to your beneficiaries. You have essentially given up control and ownership of the principal and earnings in the annuity.

Immediate and deferred annuities

There are both immediate and deferred annuities. An immediate annuity is one in which the distribution period begins immediately (or within one year) after the annuity has been purchased. For example, you sell your business for $1 million (after tax) and then retire. You purchase an immediate annuity for $1 million and begin to receive payments from the annuity issuer immediately.

A second type of annuity is a deferred annuity. With a deferred annuity, there is a time delay between when you begin investing in the annuity and when the distribution period begins. For example, you may purchase an annuity with a single payment and then not begin receiving payments for 10 years. Alternatively, you may invest a series of payments in an annuity over a period of 5 years before the distribution period begins.

Earnings tax deferred

One of the attractive aspects to an annuity is that the earnings on an annuity (i.e., the interest earned on your money by the issuer) are tax deferred until you begin to receive payments back from the annuity issuer. In this respect, then, an annuity is similar to a qualified retirement plan. Over a long period of time, your investment in an annuity may grow substantially larger than if you had invested money in a comparable taxable investment. (However, like a qualified retirement plan, there may be a 10 percent tax penalty if you begin withdrawals from an annuity before the age of 59½.)

Four parties to an annuity

There are four parties to an annuity: the annuity issuer, the owner, the annuitant, and the beneficiary. The annuity issuer is the company (e.g., an insurance company) that issues the annuity. The owner is the individual who buys the annuity from the annuity issuer and makes the contributions to the annuity. The annuitant is the individual whose life will be used as the measuring life for determining the distribution benefits that will be paid out. (The owner and the annuitant are usually the same person, but they do not have to be.) Finally, the beneficiary is the person who receives a death benefit from the annuity upon the death of the contract owner.

What are some of the common uses of annuities?

Developed by insurance companies to provide retirement income

Life insurance companies first developed annuities to provide income to individuals during their retirement years. This function is in contrast to the benefits that a life insurance policy provides to your beneficiaries after your death. Although annuities were first developed to fund an annuitant's retirement years, there is no requirement that an annuity be used only for retirement purposes. In fact, annuities may be and are used to fund other financial goals, such as paying for a child's education or starting a business.

> **Example(s):** Liz is a highly successful entrepreneur. Her business has grown far beyond what she has ever imagined, but her long hours have taken a toll on both her and her family. Liz plans to sell the company in the near future and pursue her lifelong interest in landscape painting full-time. Even though she expects a modest income from the sale of her paintings, Liz will use the sale proceeds from her company to purchase an annuity that will provide her with regular, guaranteed income for the rest of her lifetime.

Example(s): In contrast, Sam is vice president for a small manufacturing company. Unfortunately, Sam's company does not offer a retirement plan, and he has already contributed the maximum amount to his individual retirement account (IRA). Knowing that he can and needs to save more aggressively for retirement, Sam purchases an annuity to which he will contribute regularly until he retires. He will then receive a guaranteed income stream from the annuity in addition to receiving Social Security and income from his IRA.

Caution: Guarantees are subject to the claims-paying ability of the annuity issuer.

How do annuities differ from other retirement plans?

Annuities differ from other types of retirement plans in several important ways.

Contributions are not tax deductible

Unlike contributions to a qualified retirement plan, money you invest in an annuity is not tax deductible. Any money that you use to purchase an annuity will be after-tax income. (However, like a qualified retirement plan, interest and capital gains earned by an annuity will accrue tax deferred until you begin withdrawing the money from the annuity.)

Contributions are unlimited

All qualified retirement plans have limitations on how much you can contribute each year. With many plans, the amount that can be contributed is quite low. However, there is no limitation on how much you can invest in an annuity. If you win a lump sum of $1 million in the lottery, you can invest the full amount (after paying the applicable income taxes, of course) in an annuity.

May receive income for life from annuity

One of the unique features to an annuity is that you cannot outlive the income payments (assuming you elect to receive the payments over your entire lifetime). With some types of qualified retirement plans, you will receive payments from the plan only until all the money in the retirement account is depleted. There is the real possibility that you will outlive the money available in the account. Some qualified retirement plans do offer their beneficiaries the option to convert monies in the account into an annuity upon retirement.

Investment options

The money that you use to purchase an annuity may be placed in the annuity issuer's general funds pool. The money is then invested and managed by the issuer's own money managers. Some types of annuities (called variable annuities) allow you to place your annuity funds in specific investment pools, typically called subaccounts. The funds are managed by an investment advisor. You may then be able to move your annuity investments between stocks, bonds, money markets, or other types of investments.

Caution: Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees and charges for optional benefits and riders. Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.

What are the advantages to annuities?

Earnings accrue tax deferred

As noted, one of the main advantages to an annuity is that the interest generated by an annuity accrue tax deferred. Over a long period of time, this deferral of taxes on earnings is an advantage for an annuity over a comparable taxable investment.

Guaranteed payments for life

Another advantage to an annuity is that you can receive payments from the annuity for your entire lifetime. As long as you elect to receive payments over your entire lifetime when the payout period begins, you will receive the payments for as long as you are alive. Even if you live to the age of 100, the annuity issuer must make the payments to you.

No contribution limits

Unlike qualified retirement plans, there is no limit on how much you can invest in an annuity.

Many different types of annuities available

In recent years, there has been a huge increase in the number and variety of annuities available in the marketplace. There are numerous fixed annuities, variable annuities, and equity-indexed annuities that an individual can choose.

Can delay payout until later age

With most qualified retirement plans, you must begin taking money out of the plan by a certain age (usually 70½). With an annuity, there is no age limit at which you must begin receiving payments from the annuity. If you do not need the money from the annuity, you can continue to have the earnings accrue tax deferred.

Proceeds avoid probate

If you die before the distribution period begins, then the money you have invested in the annuity (plus any accrued interest or earnings) does not have to be included in your probate estate if you have named a beneficiary on the annuity. The money in your annuity will pass directly to that named beneficiary. Because of the potential delays and costs in having your assets pass through probate, most estate planners recommend that you try to avoid having assets pass through probate.

What are the tradeoffs to an annuity?

Costly fees and expenses

Annuities normally entail higher fees and expenses when compared to other types of investments, such as mutual funds and bank deposits.

May have high surrender charges

Many annuities have high "back-end" surrender charges if you withdraw your money from the annuity within the first few years. In many instances, the surrender charge may be 8 percent of any money you withdraw in the first year, then 7 percent of any money you withdraw in the second year, and continuing down to zero by the ninth year.

Contributions not tax deductible

Another disadvantage to an annuity (in comparison to certain qualified retirement plans) is that investments in an annuity are not tax deductible. You must use after-tax dollars to purchase an annuity. This is why it is normally best to place the maximum amount of funds in vehicles that allow for pretax contributions first.

Tax penalties for early withdrawals

Another concern when purchasing annuities is that the tax code imposes a 10 percent penalty tax (in addition to any other taxes owed on the payments) on withdrawals of any earnings from an annuity before you reach the age of 59½. There are certain exceptions to the imposition of this penalty, but in most cases you will have to pay an additional tax penalty if you withdraw earnings from the annuity before you reach the cut-off age.

Payout plan is irrevocable once selected

Once you elect a specific distribution plan, annuitize the annuity, and begin receiving payments, then that election is usually irrevocable. For example, you are not allowed to change an election to receive annuity payments for a five-year period to an election to receive payments over your whole life.

Income from fixed annuity may not keep up with inflation

Another tradeoff with certain types of annuities (specifically fixed annuities) is that the income from the annuity may not keep pace with inflation over the long term. Variable and equity-indexed annuities have been increasing in popularity since their investment options may offer inflation protection and growth.

Must rely on financial strength of annuity issuer

With certain types of annuities, specifically fixed but also some variable subaccounts, the money you invest in the annuity becomes part of the general funds of the annuity issuer. The annuity issuer then manages your money, its money, and other people's money as one unit. If the annuity issuer has financial problems, your payments (or the amount of your payments) may be in trouble. Unlike bank deposits at federally insured financial institutions, there are no federal guarantees on the money you invest in an annuity and only limited state provisions in the event of insolvency of the insurer. You are relying solely on the financial strength of the annuity issuer to repay your investment. For this reason, you should purchase an annuity only from an insurance company (or other annuity issuer) that has high financial ratings.

Why contribute to qualified retirement plans first?

Maximize contributions to qualified retirement plans first

If you are eligible to contribute to a qualified retirement plan either through your employer or if you are self-employed, it usually makes sense to contribute the maximum amount to one of these plans before you purchase an annuity. The primary reason for this fact is that contributions to qualified retirement plans are tax deductible (up to certain limits), whereas contributions to an annuity must be made with after-tax money. Of course, with both qualified retirement plans and annuities, the money invested accrues tax deferred until you begin withdrawals.

Why shop around for annuities?

Costs and returns may vary for annuities

Annuities tend to be more costly (in terms of fees, surrender charges, and other costs) than other types of investments, primarily because the annuity issuer provides additional benefits to you. Annuity issuers must therefore charge higher fees to cover the cost of these additional benefits. Furthermore, the returns that issuers pay on annuities can vary dramatically from one company to the next. Because new variations of annuities are constantly being introduced in the marketplace and because the financial services industry has become increasingly competitive, it can pay to shop around when buying annuities.

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