Money matters Annuities

One of the biggest challenges you will encounter on your journey toward retirement is how to make your financial resources last as long as you need them. For some people, buying an annuity—an insurance contract, which can provide you with a regular income stream—can be reassuring.

There are many types of annuities with different costs and benefits. So, if you're considering buying one, you should do two types of research:

- Compare the costs and benefits of annuities with other options you may have for retirement income. Some people may prefer to keep their money in savings accounts or investments (including real estate) where they feel they have more control and easier access to it; and,
- Compare different types of annuities to see which offers the most reliable, highest income on the best terms.

Things to think about if you're considering an annuity should be your current age, the number of years you expect to live in retirement, and the amount of income you'll have from Social Security, a pension, and/or other investments such as mutual funds or real estate.

How Annuities Work

When you buy an annuity, you pay a certain amount of money in return for future income. The contract you sign with the insurance company spells out the terms of the policy and the exact amount of income you will receive, and for how long. That amount is based on the type of annuity you choose and on the insurance company's estimate of your life expectancy.

Here's a general example of how an annuity may work: A 65-year-old husband and his 60-year-old wife buy an annuity for $100,000. While they are both alive, they receive an income of $541 each month. After one passes away, the survivor receives two-thirds of that amount, or $357 per month.

The decision whether to buy an annuity usually arises when you are close to retirement and are trying to figure out how to manage your retirement income and decide what to do with your 401(k) or other retirement savings. Some employers have arranged for their employees to use the money in their retirement accounts to buy a particular annuity. If you receive such an offer, compare the terms of that annuity with what you can receive for a similar amount of money in other annuities and other investments.

Types of Annuities

Insurance companies sell two main types of annuities—fixed and variable—but each company has its own products, with different costs and features. Here's a general description of how fixed and variable annuities work.

Fixed Annuity: Pays you a certain amount of interest—say 5 percent—for a certain number of years. After that, the interest rate can be changed, depending on the formula in the contract. There are two types of fixed income annuities:

- Fixed income deferred: With a deferred annuity, you start making payments before you collect any income. When you are ready to retire, you convert it to an immediate annuity and start receiving the income. Some people choose to put some of their savings into a deferred annuity as part of their retirement savings strategy.
- Fixed income immediate: In this case you pay the entire amount to buy the annuity at once—for example, with money from your 401(k)—and you

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start to receive income immediately.

Variable annuity: The money you pay to buy this type of annuity is invested in financial products such as money market funds or stock or index funds. As with a fixed annuity, you can buy either a deferred or immediate variable annuity.

Variable annuities carry more risk than fixed. Be sure you fully understand these risks before deciding whether to buy one:

- The amount of income you receive is not guaranteed. It varies, depending on how the investments are doing.
- Variable annuity sales commissions and fees are some of the highest in the industry. Compare the commission and all other fees to those of other investment opportunities. Be sure to find out about “surrender charges”—fees that can range from 6 to 7 percent of your investment—if you pull the money out of the annuity early.
- In some cases, annuities can increase the investor’s tax burden and can stick heirs with large tax bills. Once the investor starts withdrawing money from an annuity, the capital gains are taxed as ordinary income rather than at the lower capital-gains rates.
- You need to beware of aggressive marketing and tactics used to convince the public to buy complicated annuities without understanding how they work. The U.S. Securities and Exchange Commission and the National Association of Securities Dealers have warned the public and fined some sellers of variable annuities for aggressive or fraudulent sales tactics. So before you buy a variable annuity, check with your state insurance and securities departments to verify that the product is registered and the sales agent is appropriately licensed.
- Use the resources in the “To-Do List” at the end of this Tip Sheet to make sure you clearly understand exactly how a variable annuity you’re considering would work, and what all the costs are.

Before You Buy

There are so many different annuities, and it can be expensive to get out of an annuity you’ve bought. So don’t buy a specific product until you are comfortable with your answers to these questions:

- Did you comparison-shop? Whether you want an annuity that’s fixed or variable, are you sure you have the best deal?
- Do you have a complete list of the charges and fees? Because they are managed by investment advisors, variable annuities often cost more than fixed annuities.
- Have you researched the financial stability of the insurance company? Do not make a long-term purchase, such as an annuity, from a company that’s financially weak.
- What benefits will your spouse receive if you should die first?
- What are the “surrender fees” if you decide you want to get out of the contract? These may be about 6 or 7 percent, if you decide to opt out any time in the first several years.
- For a variable annuity, what has been the historic return on the funds where your money would be invested? How does it compare to overall market returns?
- For a fixed annuity, make sure that the guaranteed interest rate has a good chance of being higher than the inflation rate.

Your To-Do List:

- ☐ **Use AARP's online Retirement Planning Calculator** at www.aarp.org/finances to figure out all your sources of retirement income to help you decide if an annuity is right for you.
- ☐ **Get detailed explanations** of the different types of annuities and their pros and cons in "Life Advice About Annuities," at this federal government website: www.pueblo.gsa.gov/cic_text/money/annuity/annuities.htm.
- ☐ **Use an Annuity Calculator** at www.moneychimp.com/calculator/annuity to determine how much income you will receive, should you decide to purchase an annuity.
- ☐ **For checklists,** tax information and other tips to help decide if you should buy an immediate annuity, read this booklet, "Making Your Money Last for a Lifetime: Why You Need to Know About Annuities," by the Actuarial Foundation and the Women's Institute for a Secure Retirement at www.actuarialfoundation.org/consumer/wiser_annuities.htm.
- ☐ **If you're considering buying** a variable annuity, read the SEC's pamphlet, "Variable Annuities—What You should Know," on their website at www.sec.gov/pdf/varannty.pdf, and investor alerts on the National Association of Securities Dealers website. Go to www.nasd.org and type in "variable annuities" in the Search box.
- ☐ **To learn when and how much** income tax you must pay on an annuity, see "Tax Topic 410—Pensions and Annuities," on the IRS website, www.irs.gov/taxtopics/tc410.html.
- ☐ **To check out the financial status** of the insurance company selling an annuity, go to www.insureuonline.org/, a website created by state insurance regulators. The site can link you to the website of your state insurance office, which may include consumer information.

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