ANNUITIES

DEFINITION

An annuity is a contract issued by an insurance company that enables premium payments to grow tax-deferred. Policyholders can elect to receive periodic payments over a specified period of time or over one or more persons' lifetime and can also choose to keep the funds in the account for the tax-deferred growth. Annuities can be immediate or deferred, and income payments can be fixed or variable.

HOW THEY WORK

TYPES OF ANNUITIES

- Fixed – The insurance company agrees to pay the policyholder a specified rate of interest during the time that the account is growing. The insurance company also agrees that the payments will be a specified amount per dollar in the account.
- Variable – The policyholder has the option to select from a range of different investment options known as subaccounts, which are similar to mutual funds. The rate of return on premium payments, and the amount of the periodic payments the policyholder eventually receives, will vary depending on the performance of the subaccounts selected.
- Index – The insurance company credits the policyholder with a return that is based on changes in an index, such as the S&P 500. In addition, the contract value will be no less than a specified minimum, regardless of index performance.

NON-QUALIFIED VS. QUALIFIED

Non-qualified annuities are one of the investment vehicles individuals use to supplement other retirement savings resources. There is no income or contribution limit set by the IRS, but some insurance companies may limit the total investment. Premium payments for non-qualified annuities are funded with after-tax dollars, all assets grow tax-deferred, and only earnings are considered income (taxable) when distributions begin.

Qualified annuities are IRS-regulated retirement savings plans such as 403(b) tax-sheltered annuities (TSA) or an individual retirement account (IRA). Qualified 403(b) annuities have annual contributions limits and the amount contributed is deducted from one's annual adjusted gross income. As with non-qualified annuities, the funds in qualified annuities grow tax-deferred and once funds are withdrawn, they are considered as income (excluding any after-tax contributions made to an IRA) and are taxable in the year withdrawn.

IMMEDIATE VS. DEFERRED

Income payments can be immediate or deferred. Immediate annuities are those where a lump sum (single premium) is contributed and income payments usually start within six months. They are typically purchased when an individual wants to begin receiving structured, regular payments shortly after funding the contract.

Deferred annuities allow for payment of either a single lump sum or payments over a period of years, both of which occur in the future. The buyer of a deferred annuity is most interested in the advantages of tax deferral before making withdrawals.

ANNUITIZATION VS WITHDRAWAL

One can choose to take distributions from an annuity by taking out withdrawals (either systematically or periodically) or annuitizing the contract. With a systematic withdrawal plan, the policyholder chooses to withdraw funds in specified amounts and usually, there is no guaranteed lifetime or specified period payment option. The policyholder chooses instead to withdraw funds from his or her account until it is depleted, bearing the risk that the individual outlives the funds. This places the risk of a longer-than-expected lifespan on the shoulders of the policyholder instead of on the insurance company offering the annuity.

For those that decide to annuitize, the individual receives guaranteed payments over their lifetime and select from different options for the length of time they will receive income payments. Even if the amount received in annuitized payments is more than the annuity contract value, the insurance company must continue to pay that amount until the annuitant passes away.

DISTRIBUTION PERIODS

Annuity distributions can begin at the date stated in the contract and come with different time period options:

- Payments for a fixed period (e.g., 10, 15, or 20 years)
- Payments of a fixed amount, where payments are for a certain amount and the insurance company determines how long those payments will last
- Life income option with income payments lasting for the lifetime of the annuitant
- Life option with period certain, meaning that if the annuitant dies before the end of the period certain (e.g., 10, 15, or 20 years), a beneficiary will receive payments until the end of the period

DISTRIBUTION AMOUNTS

The amount of the payments depend on several variables, including the amount invested, the return earned on that amount, length of time of premium payments, and the period of time for which payments are guaranteed. These payments can be a fixed amount stated in the annuity contract, or they can be a variable amount if a variable or index annuity.

TAXATION OF DISTRIBUTIONS

Distributions from non-qualified annuities (excluding annuitization) are viewed first as a withdrawal of earnings, also known as "Last-In-First-Out" or LIFO. Those withdrawals are fully taxable until withdrawals begin to include initial contributions. Payments from an annuitized contract are taxed according to an exclusion ratio.

EXCLUSION RATIO

For income payments from an immediate annuity or annuitization, part of each payment is considered to be a return of principal, which is not taxed. The remaining portion of the payment consists of interest earnings and is taxable. The exclusion ratio determines the taxable and nontaxable portions of each payment and is calculated by dividing the total amount invested in the contract by the total amount expected to be paid out by the contract. The exclusion ratio is no longer used when all principal in the contract has been received. When the entire amount of principal has been exhausted, the entire annuity payment will then be taxable.

ESTATE PLANNING

Annuities avoid probate upon the death of the annuitant as long as a beneficiary is designated. Neither non-qualified nor qualified annuities are eligible to receive a step-up in basis and will be subject to income taxes (excluding any after-tax premium payments/contributions). Annuities are considered as part of one's gross estate and will be included for purposes of calculating how much, if any, estate taxes are due.