

Deferred Annuities for Retirement

2004



Centra Financial Services, LLC

Located at:

CENTRA CREDIT UNION

601 Union Street, Columbus, IN 47201

Office (812) 372-8811

Fax (812) 372-1088

Deferred annuities offer a tax-favored way to save for retirement, and once you're in retirement they provide several ways to withdraw your money, including the option of receiving a guaranteed lifetime income.

When you buy a deferred annuity, you contract with a life insurance company and make either a lump-sum premium payment or a series of payments over a number of years. Your earnings accumulate tax deferred, which means you don't pay income taxes until you make withdrawals.

When retirement rolls around, you can take either a lump sum or partial withdrawals, or you can annuitize, which means you make an irrevocable decision to convert your nest egg into a guaranteed stream of income payments.

Annuitization options include income for a specified period or specified amount, income for your lifetime, income for the lifetime of you and your spouse or joint annuitant, or some combination of these choices.

Q: What are the two main types of deferred annuities?

With a **fixed annuity**, the insurance company credits your account with a fixed rate of return and guarantees your principal and a stated interest rate for a specified period of time. After that, the rate is reset periodically to reflect changes in market interest rates, although there's a minimum guaranteed rate.

If you annuitize a fixed annuity, you receive fixed income payments, or with some annuities, payments that are adjusted for inflation.

With a **variable annuity**, you choose where you want your money invested from a selection of money market, bond, or stock subaccounts. Variable annuities are subject to market risk and your principal isn't guaranteed, nor are specified returns. Instead, returns vary depending on the performance of the underlying investments you select. However, most variable annuities also offer fixed-rate account options that provide a guaranteed minimum interest rate.

You can move your money among the subaccount options within a variable annuity without incurring current income taxes on your earnings. Or you can transfer your money tax free to another annuity contract through a *1035 exchange*.

If you annuitize, your options may include fixed income payments, inflation-adjusted payments, variable income payments that fluctuate based on the performance of the underlying investments you select, or a combination of these options.

Variable annuities have a death benefit feature that guarantees if you die before you annuitize, your

beneficiary will receive the greater of the market value of your account or the amount of your purchase payments, less any withdrawals. Some variable annuities offer a *stepped-up* death benefit, which periodically adjusts the guaranteed amount to lock in any investment gains.

Deferred annuities are designed to be held for the long term. So if you withdraw money within a certain period of time after a purchase payment, typically six to eight years, most insurance companies assess a sales charge, called a surrender charge.

And if you withdraw money before age 59½, you'll generally incur a 10% tax penalty in addition to the ordinary income tax due on your earnings. Plus, you have to hang on for the long haul to give the benefit of tax deferral time to offset an annuity's annual costs.

Q: What about buying a deferred annuity to fund an IRA or employer-sponsored retirement plan?

Before you buy a deferred annuity, first take maximum advantage of tax-favored retirement plans available to you, including a traditional IRA, Roth IRA, or employer-sponsored retirement plan, such as a 401(k) or 403(b). That's because in addition to offering tax deferral, these plans may be either tax deductible or tax free, or offer employer-matching contributions.

You can buy a deferred annuity to fund an IRA or employer-sponsored retirement plan. However, since these tax-advantaged plans already provide tax deferral, you get no additional tax advantages from an annuity.

Therefore, the Securities and Exchange Commission says you should consider an annuity for use with an IRA or employer-sponsored retirement plan only for an annuity's other features, such as the death benefit or guaranteed income option.

Deferred annuities that fund IRAs or employer-sponsored retirement plans are subject to the tax rules for those plans. For instance, the IRS limits the amount you can contribute, and you have to begin minimum withdrawals soon after age 70½. In contrast, with a non-qualified annuity there are no IRS limits on the amount you can contribute, and you aren't required to begin withdrawals until the age specified in your contract, typically 85 or 90.

Q: What should I consider before buying an annuity?

Take the time to review an annuity's contract, sales materials, and prospectus for essential information about investment options, fees, surrender charges, death benefit features, investment risks, and withdrawal and payout options.

Compare the benefits and costs of a variable annuity to other variable annuities, as well as to other types of investments such as mutual funds. And since annuities are not government insured and are not products of federally insured institutions, check out the insurance company's financial strength ratings.

Equally important, because an annuity's earnings are taxed differently than some other types of investments, get all the details before buying and consider consulting a tax advisor. For instance, all of an annuity's earnings — both dividends and capital gains — are taxed at ordinary federal income tax rates. In contrast, long-term capital gains from mutual funds and stocks are subject to the maximum capital gains rate of 15%.

Moreover, beneficiaries owe federal income tax on the taxable portion of an annuity's death benefit. That's in contrast to mutual funds and stocks that currently *step-up* in basis and pass to heirs free from federal income taxes on unrealized gains, and also in contrast to life insurance death benefits that beneficiaries inherit income-tax free.

If you're considering exchanging your current annuity for a new one, weigh the decision carefully since you may incur surrender charges on your current annuity, or be subject to a new surrender charge period with a new annuity.

Likewise, get all the details before exchanging your annuity for an annuity with a bonus feature. Bonus annuities pay a credit based on a specified percentage of purchase payments, but their higher fees and charges may outweigh the benefit of the credit offered.