The TRUTH about Annuities

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Wilson Financial Group is an fee only Alabama Registered Investment Advisor.

WHAT do we think, say, and do with our money?

Too often, we base our thoughts, phrase our words, and take action based on myths that have been passed down from parent to child, financial advisor to client, real estate agent to homebuyer, car salesman or insurance agent to consumer, from colleague to colleague, neighbor to neighbor, or friend to friend. The problem is that when financial reality hits--perhaps in our 40s, 50s, or even later--these financial myths explode, and make us wish that we had been paying closer attention to our own financial reality.

ANNUITIES

Annuities are very popular with financial advisors; they love to sell you annuities. Over my career, I have found more misunderstanding about them than any other investment. In some cases, annuities make sense, and in others they do not, but sooner or later someone will try to sell you these investments, getting into an investment is easy. Getting out is a different matter entirely.

Today, for all practical purposes, there are five main kinds of annuities: ***a single premium deferred annuity, an immediate annuity, a variable annuity, an index annuity, and a tax-sheltered annuity.*** Each have different strengths and weaknesses and different possible solutions.

The difference between the annuity and these other investments is that, in most cases, annuities carry the highest commission percentage of them all, which is why brokers love them so. Usually the fee that the person "earns" by selling you an annuity is around 5% to 8%.

An annuity (regardless of what kind of an annuity it is) is a contract (policy) between you as the policy holder and an insurance company. This depends on what kind of an annuity you have

With the exception of an immediate annuity, all annuities defer income taxes owed on all of interest or gains that your original deposit has earned until the money is withdrawn by either you or your beneficiaries. In essence, they work for you as a tax shelter--a big draw of annuities. The true advantage of this is that your money is allowed to stay in the account earning interest or growing for you.

Most annuities have what is known as a surrender period, or set amount of time during which you have to keep the majority of your money in the contract. Most surrender periods last from five to 10 years. Most contracts will allow you to take out at least 10% a year of the accumulated value of the account, even during the surrender period. If you take out more than that 10%, you will have to pay a surrender charge on the amount that you have withdrawn above that 10%.

SINGLE PREMIUM DEFERRED ANNUITY

One of the most popular annuities is the Single Premium Deferred Annuity. The SPDA got its name because people deposit a single premium, or lump sum, in the policy, and deferred because the taxes are postponed until money is withdrawn. An SPDA is a contract between you and an insurance company that guarantees you a specific interest rate for a specific period of time. The length of time the interest rate is guaranteed can vary from one to seven years. In most cases the longer the guarantee, the higher the interest rate. This type of annuity is most easily compared to a certificate of

deposit at a bank. In both cases, you get a guaranteed interest rate for a period of time. The difference, however, is that with a certificate of deposit, you will be paying taxes each year on the interest you have earned, even if you don't withdraw it. With the SPDA, you will not. That is the difference.

IMMEDIATE ANNUITY

An immediate annuity is a contract with an insurance company that guarantees you an immediate fixed income for the rest of your life, and, in some cases, continuing for a certain period even after your death. For this promise, however, you must sign over all the money the you have deposited in the annuity to the insurance company with full knowledge that you will never be able to touch it again, apart from receiving the monthly income. The amount of income you will receive is based on your age, the current interest rates, and the maximum amount of time that you have chosen for the company to have to pay out that stream of income, even if you were to die.

If you were to choose life only, the company would pay you a certain amount of money every month starting immediately for the rest of your life. These fixed payments would continue like clockwork for as long as you are alive, even if you were to live another 100 years. You cannot outlive the income stream of an annuity no matter what option you choose. If, however, you opted for life only, and you died the month after you had started to receive this income, too bad--the payments stop and your beneficiaries get nothing. The reason that this option gives you the highest monthly income is that they know that once you die, they're off the hook, for it is for your life only. These monthly payments are based on your age and medical history as well as the current interest rate environment and an insurance company can usually call it pretty close as to how long you are projected to live. If they're wrong, and you die sooner than projected, they win big time. If you live your full life expectancy, then they're still perfectly happy, for they had already figured those numbers into your monthly payments. If they're wrong again, and you live far longer than expected, well, they figure that doesn't happen very often, so it's no big deal. Those looking for a guaranteed lifetime monthly income with some tax benefits should consider this type of annuity.

VARIABLE ANNUITY

With mutual funds gaining such ground in the recent past, receiving billions of investors' dollars, the insurance companies wanted to get into the act. So they created what they called a variable annuity. A variable annuity is also a contract with an insurance company for a specific period of time, but when you deposit money into a variable annuity, the money is used most often to purchase different mutual funds within the insurance contract. The main draw of a variable annuity is that, as is the case with all annuities, you enjoy the so-called privilege of tax deferral. Even if you buy and sell a different mutual fund every day, you will not have to pay taxes on your gains until you actually withdraw funds from the annuity. This always appears to be a great benefit of the variable annuity, especially if you have large gains in a mutual fund not held in a variable annuity that you have wanted to sell, but haven't done so, because you'd have to pay so much in taxes.

INDEX ANNUITY

In their struggle to keep up with mutual funds, around 1994, the insurance industry introduced another new kind of annuity, the Index Annuity. The reason for this new product was their desire to capture some money that was pouring into mutual funds that simply tracked the indexes, known as index funds, such as the Standard and Poor's 500 index. The Standard and Poor's 500 index is made up of 500 stocks that are actually more a gauge of what the entire stock market is doing than the traditional Dow Jones Industrial Average that we hear about every day. The reason this is true is that the Dow Jones Average is calculated from only 30 stocks, realistically not an overview.

Here's how they work. Like all annuities, an index annuity is a contract with an insurance company for a specific period of time. The surrender period on an index annuity is usually about 7 to 10 years. The index annuity tracks an index such as the Standard and Poor's 500 index, and your return on your money will usually be a percentage of what that particular index did for your corresponding investment year. For instance, let's say your index annuity happens to track the S&P 500 index. If the S&P 500 index goes up, you would get a set percentage of what the yearly return of the index was from the time you deposited the money in this annuity until one year from that date, up to a pre-set maximum. Index annuity captures the positive but eliminates the negative.

TAX SHELTERED ANNUITY

Last, but not least, is the TSA that many many school teachers and hospital workers are offered in their retirement plan. The TSA really falls more into the category of a retirement plan, for the money that is invested

Myth: It is great to own annuities in my retirement accounts.

Reality: What you need to know is that, even though there are exceptions, holding an annuity within a retirement account is one concept that I have never agreed with. With the exception of the Roth IRA and Non Deductible IRA, all retirement plans--the traditional IRA; 401(k), 403(b), SEP-IRA, KEOGHs, SIMPLEs--are tax-sheltered vehicles funded with pre-tax dollars. In other words, you fund these plans with pre-tax dollars, and taxes on these funds, along with the growth of these funds, are deferred until the money is actually withdrawn.

Annuities, remember, can be funded with pre-tax or post-tax dollars. So let's say that you have some money sitting in your money market account which you have already paid taxes on and you want to shelter it from current taxes. One way to do it would be to deposit your money into an annuity. Until you withdraw it, all your growth and interest is sheltered from taxes. In other words, an annuity offers you the same tax-deferring benefits as a retirement account does. What sense does it make to hold a tax-shelter vehicle like an annuity in an already tax-sheltered account like a retirement plan? It does not!

When would it make sense; if you are approaching retirement age and you want to invest in the market for growth but are afraid of losing money and you are willing to take a smaller profit if you are guaranteed never to lose a penny. The index annuity accomplishes this goal, even if it is in your IRA, it can still make sense.

For the privilege of having your taxes deferred the insurance company where your variable annuity is held, is charging you many fees, as well as the potential surrender charge. These charges are in addition to the management fees and additional expenses that each mutual fund charges as well. In most cases, the fees for the insurance companies alone will amount to about 1.5% - 2% a year, right out of your pocket. Now, whether these make sense even outside a retirement account is something that you have to decide, but within a retirement account, if you ask me, this is way too hefty a price to pay for a privilege that is already inherent in your retirement account. Remember all retirement accounts are tax deferred regardless of what your money is invested in.

Let's look at this a little more closely. Let's say that you have two IRAs, with $25,000 in each. One is invested in a variable annuity where you divided all your money equally among five mutual funds. The other $25,000 is in a IRA invested directly in the same five mutual funds, but not in a variable annuity. Let's say over the next 15 years the mutual funds averaged a total of 8.5% return. How much do you have in each IRA account after those 15 years?

In the first one, invested with the variable annuity, you have $68,976, whereas, in the second one, invested directly into the mutual funds, you have $84,994. That is a $16,018 difference. Why? The variable annuity charges about 1.5% a year in fees that you did not have to pay in the mutual funds you invested with directly.

Another consideration is that most annuities carry what is known as a state premium tax. This tax varies from state to state, but is levied on the amount you originally deposited into the annuity, and must be paid either when you surrender the annuity or if you annuitize the annuity. The tax can vary from .25% if the money was in a qualified plan such as an IRA, all the way up to 2.50% if it was in an annuity outside of a retirement plan. Unfortunately, this tax is seldom disclosed before one buys an annuity. In fact, most agents who sell annuities do not even know of its existence. But it exists, and in most cases it is another unnecessary fee that cuts into you overall return.

Myth: With money you want to invest outside a retirement account, a variable annuity is a great way to invest in the market and not have to worry about taxes every time you buy or sell.

Reality: It will not save you taxes in the long run. In theory, a variable annuity will save you taxes, but only in the short run, not over the long haul--which defeats the purpose for most people who buy annuities. With a variable annuity, it is true that every time you buy or sell a mutual fund within the annuity, you do not pay taxes. It is also true that if the mutual funds you are invested in through the variable annuity pay a distribution at the end of the year (known as a capital gains distribution), again you do not pay taxes on those distributions.

In a variable annuity, you pay taxes when you withdraw your money. At what rate? You pay ordinary income taxes. Unlike a mutual fund where, if you had held it for 12 months or more, you would only have to pay the capital gains rate and for some people, that rate could be quite low. By purchasing a variable annuity, you give up the right to pay capital gains tax rates as you opt for ordinary income tax rates instead.

But with the variable annuity now you have passed this tax problem down to the kids, because when they take the money out of the variable annuity, they will also have to pay income taxes on any of the growth of your funds, never mind the additional fees and the state premium tax cutting into your return. If you had simply purchased good mutual funds not in a variable annuity, and never took the money out, when you die and leave those funds to your kids via your will or trust, they will receive what is called a step up in cost basis on the value of those funds based on their worth the day you died. If they then sold those funds after they inherited them, and before there was an upward price swing, they would not owe a penny in income taxes.

EXAMPLE:

You put $25,000 into a variable annuity, and by the time you die, your money has grown to $125,000. Your kids inherit the money, and they withdraw it, as most kids tend to do. They will owe income taxes on $100,000, along with any other fees- the difference between what you originally put in, $25,000, and what the money is now worth, $125,000, which is $100,000.

Let's say you put that same $25,000 into some great stocks, tax-efficient mutual funds, and when you die, it is again worth $125,000. Your kids inherit the money, and they withdraw it in the same way. Here is the difference: when your kids inherit an investment such as mutual funds real estate or stocks from you (but not an annuity, a traditional IRA or retirement plan), they get what is called a step up in basis on this money, which simply means that their new cost basis in this investment is based on what it was worth the day you died. If it was worth $125,000 on that day then that is their new cost basis for tax purposes. Now if they turn around and sold this investment for $125,000, since their cost basis was $125,000 and they sold it for $125,000 there was no gain, and no gain means that they will not owe one penny in income taxes.