[Variable Deferred Annuities: One Size Does Not Fit All]

Variable Annuities

Are you trying to decide whether it's a good deal to buy a variable annuity? The reality is that while variable annuities can be beneficial to some long-term investors, in many cases, the costs of fees and charges may outweigh the benefits. The bottom line: Pay attention to the terms of the contract by watching out for fees and charges.

An annuity is an investment product often purchased through an insurance company that provides a series of payments over time. The annuity payments can be used for retirement income. A ***fixed annuity*** provides periodic payments in an amount that does not vary over time. A ***variable annuity*** provides different periodic payment amounts because the returns on the underlying investments vary according to gains, losses, and investment expenses.

Variable annuities have three basic features:

- The earnings are tax-deferred until they are paid.
- The payout choices include annuity options that can provide lifetime income
- There is often a death benefit.

Variable annuities can be purchased from an insurance company with a single payment or a series of payments, and there is a range of investment options available.

Variable annuities have an ***accumulation phase*** when premiums are paid and a ***distribution phase*** when either a lump sum or annuity payments are made. The variable annuity is "deferred" when the distribution happens at a time in the future, rather than immediately.

Issues to Consider in Purchasing a Variable Deferred Annuity

Do you need or want an opportunity to save for retirement beyond contributing to an IRA and 401(k)? If you are fortunate enough to have inherited a large sum or if you already have contributed the maximum amount to an IRA and 401(k), a variable annuity offers another opportunity to save without an annual contribution limit. Like IRAs and 401(k) plans, variable annuities offer the opportunity to invest money on a tax-deferred basis, meaning that you pay no taxes on the income and investment gains from the annuity until you withdraw the money.

Should you die before collecting payments, some variable annuities provide a guaranteed amount to a beneficiary even if the stock market has dropped.

Know When to Hold Them!

Variable annuities can make sense for investors prepared to hold on to them for a long time (a minimum of 6-8 years), as well as for those who like the security of fixed interest rates, or who want the option to have guaranteed payments throughout their lifetimes. They can also make sense for those who have maxed out on IRA and 401(k) contributions and who would like to save more for retirement.

When you withdraw your money from an annuity, the earnings on the annuity investment will be taxed as ordinary income – at whatever your tax rate happens to be – anywhere from 10% to 37%. Other investments such as stocks and bonds, are taxed at lower capital gains rates from 10% to 20%.

Each of these fees will lower your investment return:

Administrative Fees: These cover recordkeeping and other administrative expenses and can be a flat fee or a percentage of the annuity account's value.

Bonus Credits: In an effort to attract investments, some insurance companies are offering contracts with bonus credits – generally ranging from 1% – 5% of the purchase payment. These contracts often come with higher surrender charges, longer surrender periods and higher mortality and expense risk charges that significantly erode the value of the bonus.

Mortality/Expense Risk Charge: This is an annual charge that the insurance company assesses to cover the insurance risks it assumes. A typical mortality/expense risk charge is 1.25%.

Surrender Charge: If you withdraw your money within a certain period after purchasing the annuity, typically between 6 and 8 years, you will pay a surrender charge. Even if you switch from one annuity to another, a new surrender period begins again.

Tax Penalty: The IRS will take a 10% early withdrawal tax penalty if funds are withdrawn before age 59 1/2.

Other Charges: Underlying fund expenses may be imposed depending on the mutual funds within your annuities, such as sales loads. Finally, most special features such as death benefits, guaranteed minimum income benefits, or long-term care insurance will carry additional fees and charges.

Conclusion

Anyone considering variable deferred annuities should request clear and concise figures on all fees and charges. Also, you should ask whether the person recommending the variable annuity will get a commission if successful in selling it. Most importantly, assess whether the costs outweigh the benefits and request a prospectus from the sales agent. The prospectus contains important information on fees and benefits.

Review: Before You Buy a Variable Annuity . . .

- Are you buying to save for a long-term goal, like retirement, and do you expect to take the payments in fixed amounts for the rest of your life?
- Do you understand how the money is invested, including the risk and possible rates of return?
- Do you understand all of the fees and expenses that the variable annuity charges? (administrative expenses, surrender charge, mortality and expense risk charges, underlying fund expenses)
- Can you stay in it at least long enough to avoid paying surrender charges or until age 59½?
- Do the expenses outweigh the benefits of the tax deferral?
- If there is a bonus credit, will the bonus outweigh all of the fees and charges?
- If you are exchanging one annuity for another, do the benefits outweigh the costs?

Resources

U.S. Securities and Exchange Commission (SEC), www.sec.gov
Variable Annuities: What You Should Know

Financial Industry Regulatory Authority (FINRA), www.finra.org
Variable Annuities: Beyond the Hard Sell

National Association of Insurance Commissioners (NAIC), www.naic.org
Buyer's Guide for Deferred Annuities

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