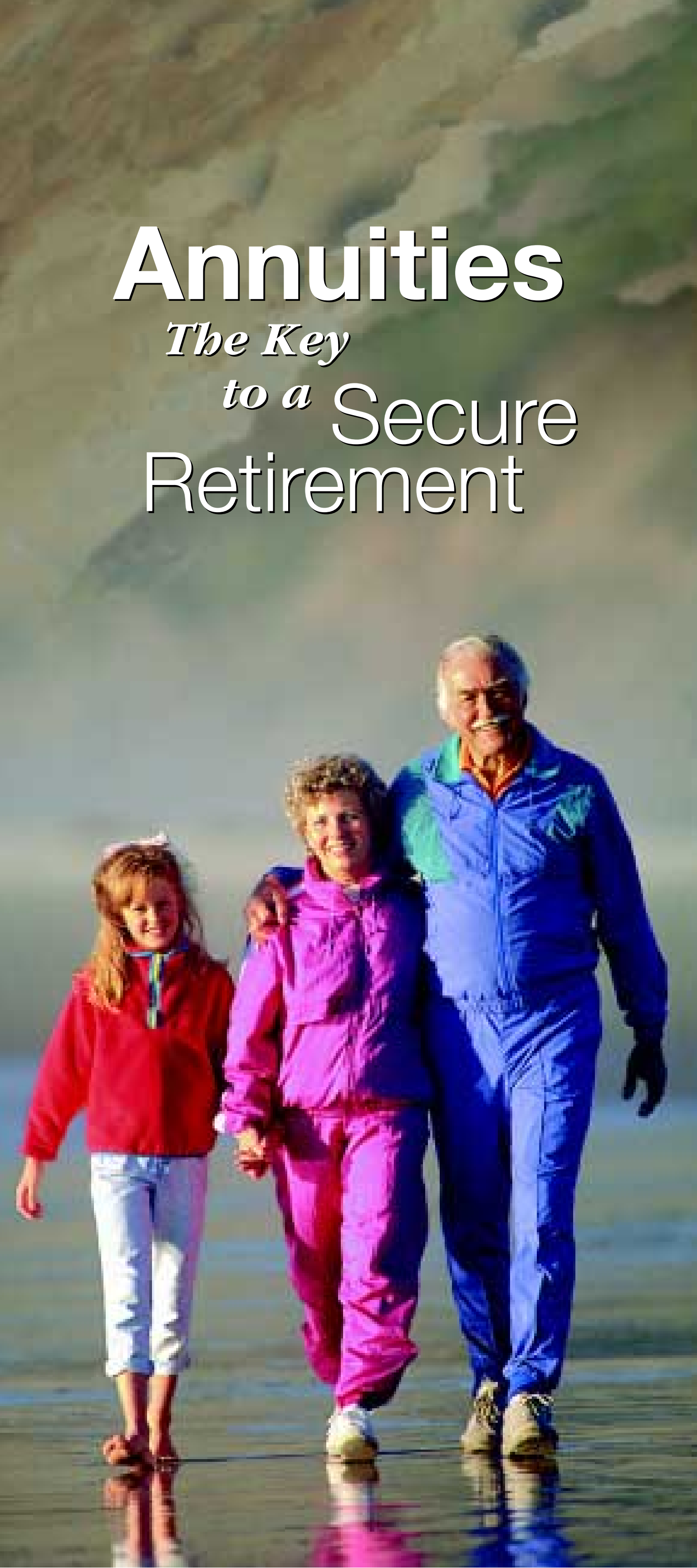
Annuities

The Key to a Secure Retirement



Saving for retirement is crucial, and making sure those resources last throughout your lifetime is just as important. Annuities do both—helping you save, then offering you a steady stream of income you cannot outlive.

To improve financial security in retirement, more and more people are including annuities in their financial planning. The American Council of Life Insurance has prepared this guide to help you understand how annuities can fit into your retirement plan.

In this guide, you will find information on what you should know before purchasing an annuity. It describes the different types of annuities and how they work, the various methods of funding annuities, and the many ways you can receive annuity income.

Annuities are a long-term savings plan.

Retirement Today Requires More Planning

Americans are living longer than ever. For many of us, retirement will last 20 to 30 years, or more. Unfortunately, surveys show that many Americans are not paying enough attention to retirement planning and may not be fully prepared for the financial impact of long retirements.

Tomorrow's retirees are likely to have a very different retirement than previous generations. Fewer workers these days are covered by traditional defined benefit pension plans, which typically are funded entirely by their employers and provide a benefit that guarantees a steady stream of retirement income for life. Furthermore, Social Security is not likely to provide the level of income earlier generations enjoyed. Consumers need other ways to make up for these shrinking sources of income. Annuities can help fill this gap.

Annuities are long-term savings plans. They are the only financial planning tool that can help you save and then provide you with a variety of payout options, including a secure and steady stream of income you cannot outlive. Consumers who have purchased an annuity say it is an important source of their retirement security, preventing them from becoming a financial burden on their families.

How an Annuity Works

An annuity is a flexible retirement planning tool. It allows your retirement savings to grow on an income tax-deferred basis and then allows you to choose a payout option that best meets your need for income when you retire—a lump sum, income for life, or income for a certain period of time. An annuity often is described as the opposite of life insurance—it pays while you live, and life insurance pays after you die.

Why Buy an Annuity?

There are many different reasons to purchase an annuity. One of the biggest advantages according to annuity owners is that it allows savings to grow without any current tax, since earnings on an annuity are not taxed until payouts begin.

Many others say they like annuities because an annuity provides a steady stream of income they

cannot outlive, a particularly useful feature for those who do not have a defined benefit pension plan.

Annuities are flexible. Generally, you decide how much money you want to put into an annuity, what type of investment risk you want to assume, and how and when you want to start taking payouts. If you choose a variable annuity, where your premiums are invested in stock or bond funds, you can respond to fluctuations in the market and change how your balances are invested with no tax consequences. When you are ready to receive retirement income, you can convert your annuity from a long-term savings plan into a variety of payout options.

In a 1997 Gallup survey, people who had purchased an annuity said they believed annuities:

- Have a good rate of return.
- Provide a long-term savings plan.
- Are an important source of retirement security.
- Are an easy way to save for retirement.
- Can ensure a surviving spouse has a continuing income.
- Provide flexibility in how payouts are received.

Annuity Benefits

Some of the benefits of buying annuities are:

- **Tax deferral** Taxes on annuity earnings are deferred until you start receiving payouts.
- **Response to market changes** You can move assets in a variable annuity from one fund to another without incurring any current taxes, giving you flexibility to respond to changes in the market or in your retirement planning needs.
- **Beneficiary protection** If you die before you begin receiving payouts, annuities generally have an insurance feature that guarantees your heirs will receive either the amount you contributed plus interest or the market value of the funds in your account, whichever is greater.
- **Withdrawal flexibility** You have flexibility in how you receive annuity payouts, including a lump sum, a systematic withdrawal where you collect a set amount regularly until you have received the full value of your account, or an arrangement where you collect a steady stream of income for as long as you live.
- **No limit on contributions** There are no tax code restrictions on the amount you can contribute to your annuity, giving you extra flexibility you don't have with a 401(k) or IRA.

- **Timing flexibility** Annuities are more flexible than other retirement savings products. Unlike IRAs and 401(k) plans, you do not have to begin receiving payouts at age 70 1/2.

  Since annuities are designed to provide long-term savings, you may pay a 10 percent tax penalty on the amount received before age 59 1/2, in addition to paying ordinary income taxes. However, the tax penalty does not apply to certain lifetime payouts or if you become disabled or die.

Selecting the Right Kind of Annuity

There are a variety of things to consider before purchasing an annuity. First, you should review all your retirement savings options and take advantage of retirement plans, such as a 401(k) or similar plan sponsored by your employer.

Once you have contributed what you can in any available employer-sponsored plan, an annuity can be one excellent way to increase your financial security and prepare for retirement.

Ask yourself a few questions to determine what you want to achieve with the annuity. Look at your total financial picture when answering the following questions:

- How much guaranteed income can you expect to receive from Social Security and your employer-sponsored pension plan(s)?


Ask yourself
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- Do you want to receive income immediately, or do you want your savings to grow, tax-deferred, until you need it in the future?
- Are you willing to tolerate fluctuations in the value of your savings?
- Do you want to finance the annuity through a series of payments over time or in one lump sum?
- Are you concerned about outliving your income?
- Do you want to receive payouts for a certain period, or for life?
- Do you need to ensure that your spouse or other dependents have an income?

With the answers to these questions, you are ready to consider the different types of annuities that are available.

If you want to begin receiving income immediately, consider an **immediate annuity,** which converts an initial lump-sum deposit into a series of monthly, quarterly, or yearly payouts right away. If you are years away from retirement, consider a **deferred annuity,** which delays the payout you receive while the money you save grows without being taxed until withdrawn. Deferral of tax on earnings is one of the major advantages of annuities over other financial products.

Types of Annuities

There are two basic types of annuity contracts—fixed and variable. Both include a variety of contribution and payout options.

Fixed Annuities

With a fixed annuity, the premiums you pay earn a fixed rate of return from the life insurance company. When you decide to begin receiving payouts, you are guaranteed a fixed payout every month.

The new **equity-indexed annuity** is a variation of the fixed annuity. With this type of annuity, your account accumulates at a minimum fixed rate of return. Your account also may earn additional interest based on the performance of an equity index. Generally, the indices used are widely reported common stock indices, the most prevalent being the Standard & Poor's 500 Composite Stock Price Index.

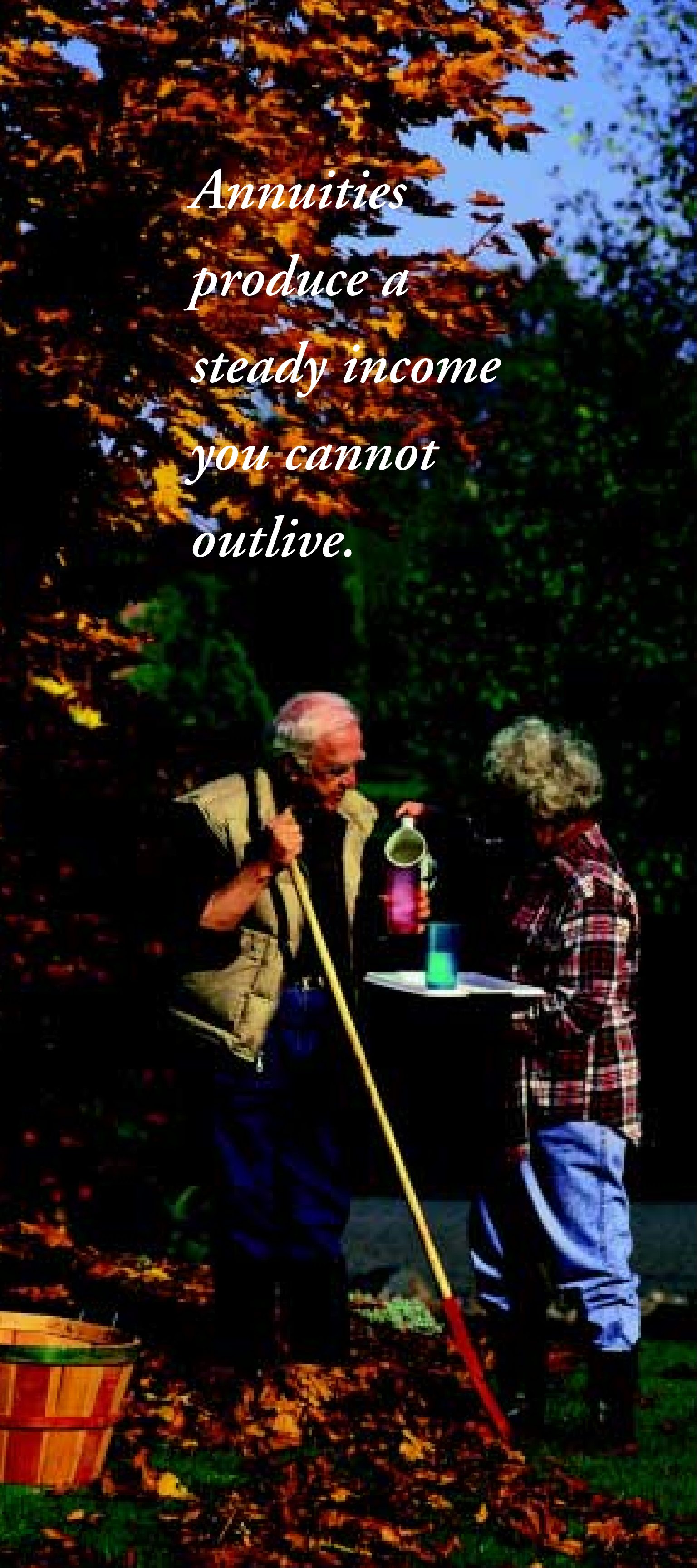
Variable Annuities

When you purchase a variable annuity, your money is invested in bond and stock funds. The value of the annuity and how much return you receive on your money depends on how well the stocks and bonds perform.

The type of funds you select depends on the level of risk you want to assume. Over the long term, variable annuities invested in equities generally reflect the growth and performance of the economy and can serve as a hedge against inflation.

With a variable annuity, you can choose to receive a fixed payout every month or a variable payout. The amount of the variable payout is based on the performance of the underlying funds in the annuity, and may vary.

Variable annuities typically offer the option to also place money in fixed-income accounts. Fixed-income accounts can help diversify a portfolio, and their stability may be appropriate if you are nearing retirement.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Financing Options

When buying an annuity, you can choose among three ways of paying for it. You can pay once with a single premium, periodically with level-premium amounts, or periodically with flexible-premium amounts. The phase before you begin receiving payouts is the accumulation period.

Single premium Immediate and deferred annuities can be purchased with a single premium payment. Retirees often purchase single-premium immediate annuities with funds received from an employer-sponsored retirement plan, the proceeds from a savings account, the cash value or death proceeds of a life insurance policy, or the proceeds from the sale of a home.

Periodic level premiums Under a periodic level-premium annuity, you pay equal premium amounts at regular intervals, such as monthly or annually, until the date the benefit payouts are scheduled to begin. The periodic level-premium annuity is always a deferred annuity, because its benefit payouts begin at some future date.

Periodic flexible premiums Under the flexible-premium annuity, premiums are paid over a period of time, but you have the option to both vary the premium amount paid and skip making deposits. A flexible-premium annuity is always a deferred annuity.

Payout Options

Annuity payouts can continue for life or for a fixed period, depending on the type of option you select. Under some options, payouts will continue to a designated beneficiary after your death.

The major payout options are:

Straight life annuity You receive income for the rest of your life with this type of annuity. It continues to pay an income as long as you live, even after all the money you put into the annuity has been exhausted. However, if you die before all the money in your account has been returned, no payouts will be made to anyone, not even your dependents. This type of annuity is recommended if you need the maximum amount of income and either have no dependents or have taken care of them through other means.

Joint and survivor annuity This annuity is paid to you as long as you live, and after your death, to your designated beneficiary as long as he or she lives. You can choose the benefit your survivor will receive upon your death. However, the option you choose for your beneficiary will affect the payout amount you receive.

Life income with refund annuity You receive income for life with this annuity. If you die before receiving an amount equal to all of the premiums you paid, your beneficiary collects the portion you had not yet received.

Life annuity with period certain Payouts are made to you for life with this type of annuity, which also features a guarantee provision: If you die within a certain period after you start receiving income, usually 10 or 20 years, your beneficiary will receive regular payouts for the balance of that period.

Other options You can receive your payout all at once in a lump sum or over a period of years in a series of payouts known as a systematic distribution.

Calculating Payouts

How much income you receive from your annuity will depend on the type of annuity you buy and how you set up your payout plan. Factors affecting your payout include:

- Your life expectancy, if you selected a lifetime payout plan.
- The premiums you paid plus any earnings.
- The rate of return the company credits your account, if you purchased a fixed annuity.
- The investment performance of the funds you have chosen, if you purchased a variable annuity.

You should compare annuity contracts offered by different companies because sales charges, interest rates, and payouts can vary.

Annuity Costs

Annuities offer several attractive features to people planning for retirement, such as, interest guarantees, a death benefit, and the ability to convert savings to a steady stream of income for life, no matter how long you live. These benefits are included in the cost of your annuity.

You may be required to pay a surrender charge if you decide not to keep your annuity contract or take a partial withdrawal. However, with most annuities, the longer you hold a contract, the smaller the surrender charge. Surrender charges are usually eliminated once you have held an annuity contract for a number of years.

For both fixed and variable annuities, you should find out what fees are associated with the annuity product and how they will affect your returns. Over time, the advantages of tax-deferred growth can eliminate any negative effect of fees on your retirement savings.

Shopping for an Annuity

Annuities are sold by life insurance companies, banks, and brokerage firms. However, only life insurance companies issue the annuities that are sold by these institutions.

Carefully review all your options when purchasing an annuity to ensure you get the type of contract that best suits your financial situation.

Be sure the insurance company issuing the annuity is reputable, service-oriented, and financially strong. You can check with your state's insurance department to be sure the company is licensed in the state.

There also are services that rate the financial strength of insurance companies, such as A.M. Best, Standard & Poor's, Duff & Phelps, and Moody's. Ratings can be found in most public libraries, or on each service's Internet site (a small fee may be charged in some cases).

Before Purchasing an Annuity

Before you purchase an annuity, there are a few things you should discuss with the agent or company representative. When buying a fixed annuity, find out the current interest rate being credited under the annuity, how often it changes, and the minimum interest rate guaranteed in the annuity contract.

If you are purchasing a variable annuity, find out what kinds of fund options are offered. A prospectus must be given to all purchasers of a variable annuity contract registered with the Securities and Exchange Commission and it must be delivered before the purchase or no later than the statement confirming the purchase. The prospectus discloses such essential information as fund objectives, operating expenses, financial statements, and investment risks. Review the prospectus for a variable annuity carefully.

Since returns from variable annuities fluctuate with the performance of the funds backing the contract, you assume the investment risk that account values may go up or down on a daily basis.

After the Purchase

After you have reviewed your options carefully and purchased an annuity, you may be entitled to a "free-look" period—at least 10 days after you receive the contract—where you can change your mind. During that time, read your contract carefully. If you decide not to keep it, the company will cancel the contract and give you a refund calculated by the terms of the contract or state law. However, rules vary from state to state, and not every state has free-look requirements. Before you purchase an annuity, ask your agent or company representative if you are entitled to a free-look.

Paying Taxes on Your Annuity Earnings

When you buy a deferred annuity, the earnings credited to your contract build up free of current federal income tax. However, once you start receiving payouts, the federal government begins to tax a portion of the accumulated earnings. If you select an option that provides a stream of payouts, part of each payout will be considered a return of earnings and will be taxed as ordinary income. The other part represents your contributions and is not taxable. This is true of both deferred and immediate annuities. You may also have to pay state taxes on your annuity earnings.

You may withdraw money from your deferred annuity in a form other than a stream of payouts.

In this case, the earnings on your account are subject to income tax before any amount is treated as a return of your contributions, which are not taxed. In addition, the taxable portion of the withdrawal is subject to a penalty tax of 10 percent if you withdraw the money before age 59 1/2, except in certain circumstances, such as disability or death.

You may want to consult a tax adviser well in advance of retirement for more information about the taxation of your annuity distributions. The Internal Revenue Service also has publications on the subject that may be helpful.

Protection by State Guaranty Associations

If you purchase an annuity, you are protected by a state guaranty association in the unlikely event the insurance company has financial trouble. Guaranty associations are created by state law to assure that the claims of an insolvent insurance company's policyholders who live in the state will be paid, subject to the limits of the law. All insurers authorized to write life and health insurance or annuities in the state are required, as a condition of doing business in the state, to be members of the association.

Guaranty associations generally cover fixed annuities and amounts in variable annuities placed in fixed-income accounts. Amounts in variable annuities placed in equity accounts are held separately and would not be affected by an insurance company's financial difficulties. Thus, there is no need for guaranty association protection.

Check with your state guaranty association to find out the level of coverage in your state. You should be aware that annuities purchased from banks do not have added protection from the Federal Deposit Insurance Corporation (FDIC), and that annuities purchased from brokerage houses do not have added protection from the Securities Investor Protection Corporation (SIPC).

Getting Help With Your Annuity Contract

If you have a concern or problem with your annuity contract once it's purchased, talk to your agent or company representative. If you are having a problem with your agent, talk to the head of the local insurance agency, and if the agency manager is unable to assist you in your request, contact the agent's company directly.

Direct your problem to the customer service department at the company's home office. Although each company operates differently, the customer service department should be able to resolve your case or forward it to the appropriate department. If you still haven't solved the problem after discussing it with the issuing company, contact your department of insurance, a division of your state government. The state insurance department handles consumers' complaints and tries to resolve them.