Solving the Annuity Puzzle

Americans hold billions of dollars in annuities, yet they are widely misunderstood. Used properly, an annuity can serve valuable purposes in personal financial planning. On the other hand, some types of annuities are widely criticized, even scorned, by some financial advisers.

Lifelong Income

What might be considered the purest type of annuity is a contract with an issuer, often an insurance company, for a stream of cash flow. Such contracts have been called immediate annuities, although they now may be labeled income annuities or payout annuities because those labels may be more appealing to consumers.

Example 1: Marie Jenkins pays $100,000 to an insurer for an income annuity. Every month thereafter the company sends Marie a check.

That may sound simple, but complications soon arise. Does Marie want to receive those checks for her lifetime, no matter how long that might be? Does she want the checks to continue to her husband Tony if he outlives Marie? A joint annuity will pay less than a single life annuity because the insurer has more risk of an extended payout.

This type of annuity has a great advantage: the promise of lifelong cash flow. More people are living into their 90s and beyond, so a lifetime annuity can help keep them from running short of money in very old age.

At the same time, Marie may worry that she'll pay $100,000 for this annuity and get run over by the proverbial truck the next month, ending her life and stopping the payments after a scant return. Even with a joint annuity, both Marie and Tony could die prematurely after receiving much less than the $100,000 outlay.

Adding Certainty

Insurers have come up with various methods of addressing these fears. One method is the period certain annuity.

Example 2: Marie pays $100,000 for a single life income annuity that includes a 10-year period certain. If Marie lives for 25 years, the insurer will keep sending her checks. However, if Marie dies after 3 years of payments, the annuity will continue for another 7 years to a beneficiary named by Marie.

Again, an annuity with this type of guarantee will produce smaller checks than a straight life annuity because the insurer has more risk. Other features may be added to an income annuity, such as access to principal, but all of these variations will reduce the amount of the checks paid to consumers.

Annuity taxation can also be complex. If this type of annuity is held in a taxable account, part of each check to Marie will be taxable, but part will be a tax-free return of her investment (see Trusted Advice box.) Eventually, after Marie has received her full investment tax-free, ongoing checks will be fully taxable.

Later Rather Than Sooner

Some annuities start distributing cash right away, as described, but others are deferred. The deferral could be a wait for some years until an income annuity starts.

Alternatively, there may be some provision for the invested amount to grow untaxed until the payouts start. These annuities may peg growth to a promised interest rate or to results in the financial markets. Often, there is some type of guarantee from the insurer of a minimum return or protection against loss. The manner of future payouts can be left up to the consumer.

Example 3: Marie invests her $100,000 in a deferred annuity taxable account. That $100,000 investment might grow over the years. At some point, Marie can "annuitize" the contract using her account balance to fund an income annuity. As mentioned, Marie's payments then will be part taxable and part an untaxed return of her investment.

As an alternative, Marie can avoid annuitizing the contract. Instead, she can withdraw money from her account balance for cash flow when she wants it. Some annuities guarantee certain withdrawal amounts. Annuity withdrawals may be fully taxable, and a 10% penalty also may apply before age 59½. Critics charge that some annuities, especially deferred annuities, can be complex, illiquid, and burdened with high fees. Read the fine print of any annuity before making a commitment.

Trusted Advice

Taxation of Annuity Payouts

- Periodic annuity payments are amounts paid at regular intervals—weekly, monthly, or yearly—for a period of time greater than one year.
- Between the simplified and general methods of computing income tax on such payments, you must use the general method if your annuity is paid under a nonqualified plan, rather than under a qualified plan such as a 401(k) or an IRA.
- With the general method, you determine the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return.
- The expected return is the total amount you and other eligible recipients can expect to receive under the contract, as per life expectancy tables from the IRS.
- Our office can help you make the required calculation.