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Annuity Basics

An annuity is a contract between you, the purchaser or owner, and an insurance company, the annuity issuer. In its simplest form, you pay money to an annuity issuer, and the issuer pays out the principal and earnings back to you or to a named beneficiary. Life insurance companies first developed annuities to provide income to individuals during their retirement years.

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Annuities are either qualified or nonqualified. Qualified annuities are used in connection with tax-advantaged retirement plans, such as 401(k) plans, Section 403(b) retirement plans (TSAs), or IRAs. Qualified annuities are subject to the contribution, withdrawal, and tax rules that apply to tax-advantaged retirement plans. One of the attractive aspects of a nonqualified annuity is that its earnings are tax deferred until you begin to receive payments back from the annuity issuer. In this respect, an annuity is similar to a qualified retirement plan. Over a long period of time, your investment in an annuity can grow substantially larger than if you had invested money in a comparable taxable investment. Like a qualified retirement plan, a 10 percent tax penalty on the taxable portion of the distribution may be imposed if you begin withdrawals from an annuity before age 59½. Unlike a qualified retirement plan, contributions to a nonqualified annuity are not tax deductible, and taxes are paid only on the earnings when distributed.

Four Parties to an Annuity Contract

There are four parties to an annuity contract: the annuity issuer, the owner, the annuitant, and the beneficiary. The annuity issuer is the company (e.g., an insurance company) that issues the annuity. The owner is the individual or other entity who buys the annuity from the annuity issuer and makes the contributions to the annuity. The annuitant is the individual whose life will be used as the measuring life for determining the timing and amount of distribution benefits that will be paid out. The owner and the annuitant are usually the same person but do not have to be. Finally, the beneficiary is the person who receives a death benefit from the annuity at the death of the annuitant.

Two Distinct Phases to an Annuity

There are two distinct phases to an annuity: (1) the accumulation (or investment) phase and (2) the distribution phase.

The accumulation (or investment) phase is the time period when you add money to the annuity. When using this option, you'll have purchased a deferred annuity. You can purchase the annuity in one lump sum (known as a single premium annuity), or you make investments periodically, over time.

The distribution phase is when you begin receiving distributions from the annuity. You have two general options for receiving distributions from your annuity. Under the first option, you can withdraw some or all of the money in the annuity in lump sums.

The second option (commonly referred to as the guaranteed income or annuitization option) provides you with a guaranteed income stream from the annuity for your entire lifetime (no matter how long you live) or for a specific period of time (e.g., ten years). (Guarantees are based on the claims-paying ability of the issuing insurance company.) This option generally can be elected several years after you purchased your deferred annuity. Or, if you want to invest in an annuity and start receiving payments within the first year, you'll purchase what is known as an immediate annuity.

You can also elect to receive the annuity payments over both your lifetime and the lifetime of another person. This option is known as a joint and survivor annuity. Under a joint and survivor annuity, the annuity issuer promises to pay you an amount of money on a periodic basis (e.g., monthly, quarterly, or yearly). The amount you receive for each payment period will depend on how much money you have in the annuity, how earnings are credited to your account (whether fixed or variable), and the age at which you begin the annuitization phase. The length of the distribution period will also affect how much you receive.

When Is an Annuity Appropriate?

It is important to understand that annuities can be an excellent tool if you use them properly. Annuities are not right for everyone.

Nonqualified annuity contributions are not tax deductible. That's why most experts advise funding other retirement plans first. However, if you have already contributed the maximum allowable amount to other available retirement plans, an annuity can be an excellent choice. There is no limit to how much you can invest in a nonqualified annuity, and like other qualified retirement plans, the funds are allowed to grow tax deferred until you begin taking distributions.

Annuities are designed to be long-term investment vehicles. In most cases, you'll pay a penalty for early withdrawals. And if you take a lump-sum distribution of your annuity funds within the first few years after purchasing your annuity, you may be subject to surrender charges imposed by the issuer. As long as you're sure you won't need the money until at least age 59½, an annuity is worth considering. If your needs are more short term, you should explore other options.

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948, or [schedule an appointment](#) with a retirement counselor today.

Source: Broadridge Investor Communication Solutions, Inc.