FINANCiAL *fitness*

By RWM Wealth Advisor Sandy Carlson CFP®, CPA, CDFA™, QKA

Find Annuities Confusing? Join the Club...

Annuities are a form of insurance. An annuity is a contract between an insurance company and an individual that is commonly used to fund retirement and to help meet specific goals including principal protection and lifetime income.

Types of Annuities

Fixed vs. Variable

A fixed annuity obligates the insurance company to make a series of fixed annuity payments for the duration of the contract. The individual invests a lump sum of cash in exchange for monthly payments that are guaranteed by the insurance company. Therefore, fixed annuities are essentially CD-like investments that pay guaranteed rates of interest. While a fixed annuity can remove market risk from the investment return, the spending power provided by the monthly payment may decline significantly over the life of the annuity contract because of inflation.

A variable annuity is a long-term tax-deferred retirement vehicle that allows you to choose from a selection of investments, typically stock or bond mutual-fund-like portfolios called subaccounts. Therefore, variable annuities involve investment risk and may lose value. Many variable annuity products offer "living benefit riders" that provide principal and/or income guarantees to help protect principal or retirement income from declining markets. There are three basic types of living benefit riders that include: Guaranteed Minimum Accumulation Benefit (GMAB), Guaranteed Minimum Income Benefit (GMIB), and Guaranteed Minimum Withdrawal Benefit (GMWB).

- GMAB – Guarantees that an owner's contract value will be at least equal to a certain minimum percentage (usually 100%) of the amount invested after a specified number of years (typically 7 – 10 years), regardless of investment performance.
- GMIB – Designed to provide a base amount of lifetime income, regardless of investment performance.
- GMWB – Guarantees that a certain percentage of the amount invested can be withdrawn annually until the original amount is completely recovered, regardless of investment performance.

Taxation of Annuities

Typically you should consider an annuity only after you have maxed out other tax-advantaged retirement investment vehicles, such as 401(k) plans and IRAs. If you have additional money to set aside for retirement, an annuity's tax-free growth may make sense, especially if you are in a high-income tax bracket. However, just like 401(k)'s and IRAs, it is important to understand that any long-term capital gains you build up in the subaccounts will be taxed at ordinary income tax rates when you withdraw them. This means that high-income investors are effectively converting long-term capital gains into ordinary income that will be taxed at higher rates. In addition, you will pay a 10% penalty on withdrawals if you're under age 59 ½.

Cost of Annuities

The fee structures of annuities can be complex and unclear. The most common fees and charges are:

- Mortality and Expense Charge (M&E) – compensates the insurance company for insurance costs and other expenses it assumes under the contract. These fees typically range from 1.15% to 1.85% annually.
- Administrative and Distribution Fees – covers the costs associated with servicing and distributing the annuity. These fees typically range from 0% to 0.60% annually.
- Subaccount Fees – management fees that are paid to the investment advisor responsible for making investment decisions. These fees typically range from 0.70% to 2.73% annually.
- Living Benefit Riders – additional fees that pertain to riders such as the ones described above. Actual fees vary by contract but typically range from 0.30% to 2% annually.
- Contingent Deferred Sales Charge ("Surrender Charge") – charges assessed to the annuity owner who liquidates the contract during the surrender period. A typical surrender charge ranges from 7% to 9% and decreases each year the contract is in force until the surrender charge reaches zero.

Before buying any annuity, you should request a prospectus and read it carefully. The prospectus contains important information about the annuity contract including fees and charges, investment options and objectives, risks, death benefits, living benefits and annuity income options. Annuities are some of the most expensive products sold, which can significantly erode investment performance. Therefore, these vehicles should not be purchased as an investment but are more appropriate if they are owned for their contractual guarantees. If you don't need to contractually solve for principal protection or lifetime income, then you probably don't need an annuity.

Sandy Carlson has over eighteen years of wealth management experience including income taxation, retirement planning, executive compensation planning, insurance, banking, trust administration and estate planning. She is a Certified Divorce Financial Analyst™ (CDFA) and also holds the QKA designation by the American Society of Pension Professionals & Actuaries. She is President-Elect of the Financial Planning Association, a Tax Instructor in the CFP Program at Queens University, and is a member of the Charlotte Estate Planning Council. Sandy values getting to know her clients and providing creative, integrated solutions for accumulating, preserving and transferring wealth.