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Understanding Annuities

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About Kevin Peters, CLU®

- Wealth Advisor with XML Financial Group for two decades and in the financial services industry since 1997.
- Focuses on assessing the unique situation of each of his clients and helping to achieve their goals through focused asset management strategies and risk mitigation.
- Has over 25 years of independent insurance experience.
- Founded Lifestyle Life Insurance Company with the goal of offering independent unbiased Insurance Services that are in the best interests of his clients.
- Holds the Chartered Life Underwriter® designation.

What is an annuity?

An annuity is a financial product issued by an insurance company that allows you to grow your money tax-deferred and receive income in the future.

You purchase an annuity with an initial premium or series of premium payments; in return, the insurance company provides interest credits to grow your value. The contract includes a surrender charge period and other provisions defining when and how to access your funds. Over time, you can take income payments through annuitization or optional income riders or withdraw funds as a lump sum, depending on your needs.

Considerations

It's important to recognize that annuities are not right for everyone. These are some of the important considerations that we will review today.

1. Different types of annuities related to you your financial goals
2. Fees & charges or the potential costs of annuities
3. Taxes- Taxation within and outside of an IRA or Tax Qualified Funds
4. Limitations of annuities as an investment
5. Benefits like principal protection and lifetime income
6. Regular review

Potential Benefits of Annuities

- **Accumulation Potential**
  Growth via a fixed rate, potential indexed interest or variable options.
- **Guaranteed Lifetime Income**
  Offers a way to not outlive your savings.
- **Market Protection**
  Some annuities protect all of your principal from market downturns, while others offer more significant potential return in exchange for greater market risk.
- **Tax-Deferral Growth**
  Interest or gains can grow without immediate taxation.
- **Avoids Probate**
  Allows for direct beneficiary designation to bypass probate.

Drawbacks of Annuities

- **Limited Liquidity**
  - Surrender charges
  - No access after annuitization in most cases
- **Complexity of Riders and Fees**
  - Additional cost for riders
  - Complexity in understanding
- **Risk of Insurance Company Default**
  - Credit risk - fixed annuities are backed by the issuing insurance company.
- **Lack of Control Over Investment**
  - Lack of flexibility
  - No direct investment in markets
- **Inflation Risks**
  - Fixed payouts unless you purchase an additional inflation rider.
  - Impact:Your fixed income becomes less valuable.
- **Higher Fees in Some Cases**
  - Administrative fees
  - Surrender charges
  - Taxation (its important to consult your tax advisor)
    - Taxable income consideration
    - No step-up basis
- **Opportunity Costs**
  - Fixed Payment Lock-In
  - Missed Investment Growth

Types of Annuities

For many Americans, securing a stable retirement means ensuring they won't outlive their savings. One way to help you achieve this is by using a portion of retirement assets to purchase an annuity. Unlike traditional investments, annuities provide a unique combination of protection, guaranteed income, and tax advantages that can help create financial stability throughout retirement.

Here's a quick breakdown of the most common types of annuities and how they can fit into your retirement plan.

Types of Annuities

Immediate Annuities
Start paying income within a year of purchase.

Fixed Annuities
Offer a guaranteed interest rate

Fixed Index Annuities
Potential for interest linked to a financial index (subject to limits) with downside protection

Registered Index -Linked Annuity
Potential interest tied to a financial index (subject to limits) with limited downside risk and higher growth potential than fixed index annuities.

Variable Annuities
Returns depend on market performance with risk to principal.

Fixed Annuities - Pros and Cons

- **Guaranteed Income Stream**
  - Predictable and reliable income stream
  - Doesn’t fluctuate with market conditions.
- **Principal Protection**
  - Protected from market risk
  - Low-risk option for those seeking stability
- **Fixed Interest Rate**
  - Guaranteed rate for a specified period
  - Rate may reset after period but still offers some guarantees
- **Tax Deferral**
  - Earnings grow tax-deferred
  - Money can grow more quickly compared to taxable accounts.
- **Payout Options**
  - Lifetime payments: Payments continue for the annuitant’s life.
  - Fixed period: Payments are made for a set number of years.
  - Joint and survivor: Payments continue for the life of both the annuitant and their spouse or beneficiary.
- **Annuitization (the process by which you convert the lump sum into a stream of regular payments)**
  - Flexibility to choose how and when you want to start receiving payments.
- **No Fees (Generally)**
  - Typically no managment fees or commissions.
  - Straightforward and predictable in terms of cost.

Fixed Annuities - Pros and Cons

- **Death Benefit**
  - Ability to pass the remaining principal to beneficiaries.
- **Limited Liquidity**
  - You will face penalties if you withdraw money early
  - Some can offer penalty-free withdrawals up to a certain percentage
- **Inflation Risk**
  - Fixed annuities may not keep up with inflation unless you specifically add an inflation rider.
  - Increases your income over time but also increases the cost of the annuity.
- **Riders**
  - Cost-of-living adjustments (COLA): Increases payouts over time to help keep up with inflation.
  - Long-term care riders: Allows you to access annuity funds for long-term care expenses.

Variable Annuities - Pros and Cons

Investment Options
- Option to choose from a range of investment options.
- The value of your annuity will fluctuate based on these investment options.

Growth Potential
- Returns have the potential to grow more than a fixed annuity.
- Can be higher risk as your investments can lose value.

Income Stream
- Choose a payout option that begins immediately or at a later date.
- Amount you receive is dependent on investment performance.

Optional Features
- Death benefit to your beneficiaries
- Riders: Optional add-on's for a fee that can guarantee a minimum level of income or other benefits

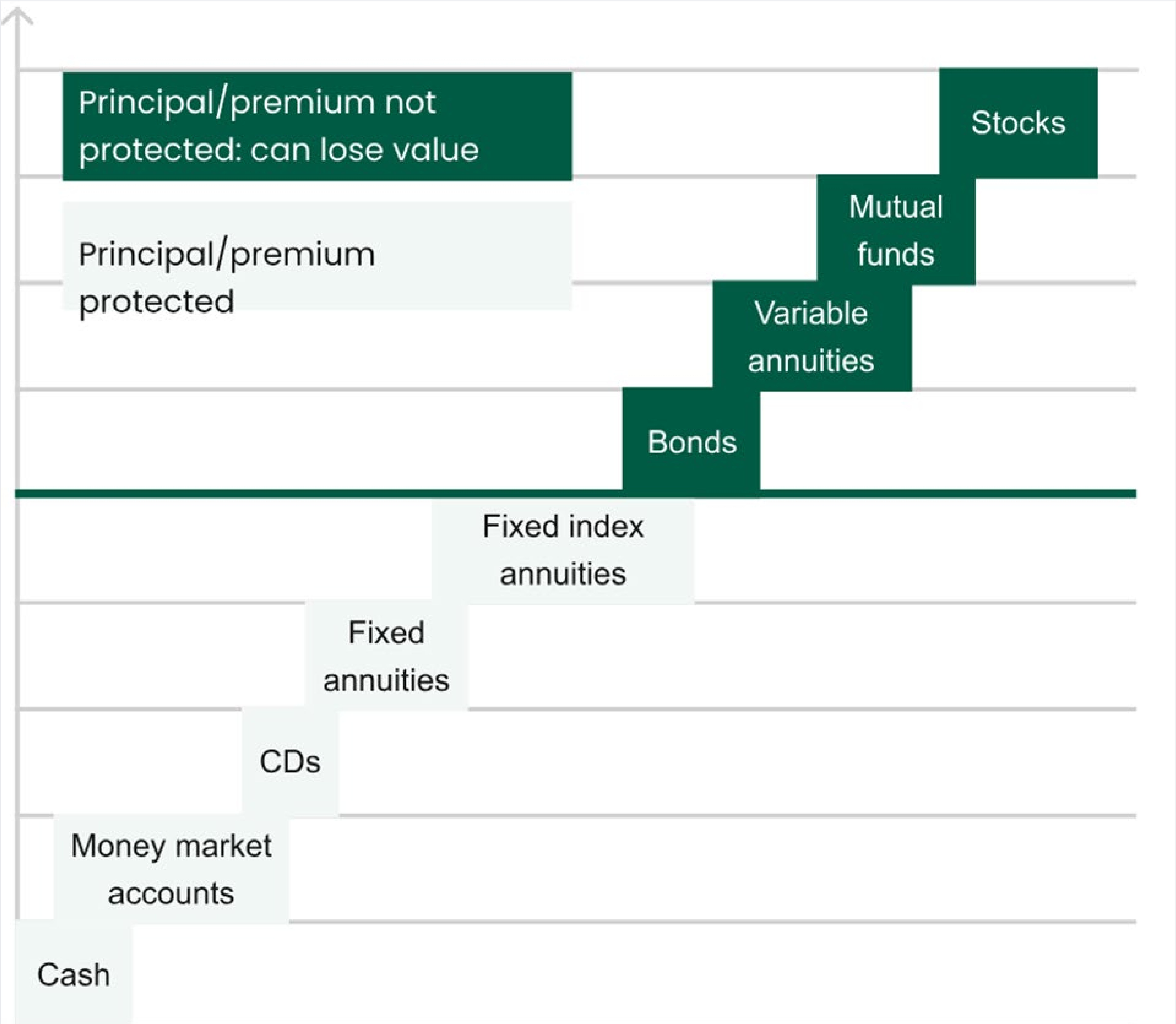
Fees
- Can be costly w/ management, insurance features, and admin costs.
- Can eat into returns.

Tax Deferral
- Earnings grow tax-deferred
- Money can grow more quickly compared to taxable accounts.

Comparing Annuity Products

Feature	Fixed Annuity	Fixed Index Annuity	Registered Index-Linked Annuity	Variable Annuity
Risk Level	Low	Low-Moderate	Moderate	High
Growth Potential	Fixed interest	Index-Linked interest potential	Index-Linked interest potential	Market-Dependent
Downside Protection	Yes	Yes	Partial	No
Tax-Deferred Growth	Yes	Yes	Yes	Yes
Guaranteed Income	Yes	Yes & Optional Riders	Yes & Optional Riders	Yes & Optional Riders

Annuity Risk Spectrum



Tips for Choosing the Right Annuity

Consider Your Goals

Evaluate Fees and Features

Consider Tax Treatment

Compare Insurers

Considering your goals

Are you looking for immediate income, future growth, or market-linked potential? Choosing which annuity will best help you achieve your goals is a matter of determining those goals and then shopping around and doing your research.

If your goal is to pay your retirement expenses and not run out of money, you may want to consider an annuity with an income rider. If you're concerned about keeping up with inflation, investigate adding an inflation rider or, perhaps, purchasing a fixed index annuity, which has more potential for growth.

Evaluate Fees

People are often unaware of or confused about the fees associated with different annuities.

An experienced financial professional can help you select the correct type of annuity for your particular needs and answer your questions about its features and fees.

Some features may come built into the products, whereas others may be available as an optional rider for an additional cost.

Consider Tax Treatment

Tax-deferral : Annuities offer tax-deferred growth, meaning you don't pay taxes on interest, dividends, or capital gains until you withdraw the funds.

Ordinary income rates : All taxable annuity income is taxed at ordinary income tax rates, not at lower long-term capital gains rates.

State taxes : Some states also have specific laws regarding annuity taxation.

Penalty exceptions : There are exceptions to the 10% early withdrawal penalty, including if you are disabled or terminally ill.

Consider Tax Treatment (Qualified Annuities)

A qualified annuity is funded with pre-tax dollars, often through a retirement plan such as a 401(k) or traditional IRA.

- Fully taxable withdrawals: Since the contributions were never taxed, the entire amount of any withdrawal or payout is taxed as ordinary income in the year you receive it.
- Early withdrawal penalties: If you make withdrawals before age 59½, you will be subject to a 10% IRS penalty on the entire amount, in addition to regular income tax.

Consider Tax Treatment (Non -Qualified Annuities)

A non-qualified annuity is funded with after-tax dollars, and only the earnings are taxed upon withdrawal.

- Taxed earnings first (LIFO): For deferred annuities, the "last-in, first-out" (LIFO) rule applies, meaning your withdrawals are considered to be earnings first, and are therefore taxable. Once you have withdrawn all the earnings, the remaining principal comes out tax-free.

Consider Tax Treatment (Non -Qualified Annuities)

- Exclusion ratio for annuitized payments: If you choose to convert your lump sum into a stream of regular payments (annuitization), each payment is partially taxable and partially tax-free. Your insurance company uses a formula called the exclusion ratio to determine what percentage of each payment is a tax-free return of your principal and what percentage is taxable earnings.
- Early withdrawal penalties: Similar to qualified annuities, withdrawals made from the earnings portion before age 59½ are subject to a 10% IRS penalty on top of regular income tax.

Compare Insurers

Because insurance companies sell annuities, they’re not backed by the FDIC like a CD or other bank accounts. Instead, they are supported by the companies' financial strength and claims-paying ability. Checking the company’s ratings from agencies such as AM Best, Moody’s, Fitch, and S&P is important to ensure you’re buying from a financially sound provider.

Additionally, their ability to provide proper and timely service to their licensed agents and customers is also essential to consider. Various customer satisfaction surveys and research companies publish information like this.

In Summary

When purchasing or reviewing your existing annuity, work with a licensed independent annuity agent, and research them via www.brokercheck.finra.org.

Choosing the Right Agent

- **Initial Conversation & Goal Setting** - A good insurance agent starts by understanding your financial goals, retirement timeline, and risk tolerance. This helps ensure any recommendation aligns with your unique needs.
- **Education & Transparency** - They'll explain annuity types (fixed, fixed index, variable, immediate, deferred) and key features like surrender charges, fees, taxes and payout options. To avoid surprises, you're encouraged to ask about costs and the insurer's financial strength.
- **Best Interest** - A licensed insurance agent must recommend annuity products that are in your best interest to help protect against generic "one-size-fits-all" pitches
- **Product Recommendations and Options** - Once you understand annuities, the agent should present tailored options, outlining benefits, potential rates, riders and drawbacks. Comparing options lets you make an informed decision

Choosing the Right Agent

- **Purchasing & Ongoing Support** - If you choose an annuity, the agent handles paperwork and helps to ensure that the annuity is appropriate for you. Periodic reviews will help confirm your annuity continues to meet your evolving financial goals. Buying an annuity should fit into your broader retirement plan—never feel rushed or hesitant to seek a second opinion. Annuity.org has a network of vetted, licensed annuity agents ready to guide you, to help insurance transparency and alignment with your long-term objectives.

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Thank You!

Speak to your XML Wealth Advisor to learn more about how annuities may or may not fit into your financial plan.

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