Annuities: What They Are and How They Work

Annuities can provide a stream of payments later in return for an investment now, but they have special features.

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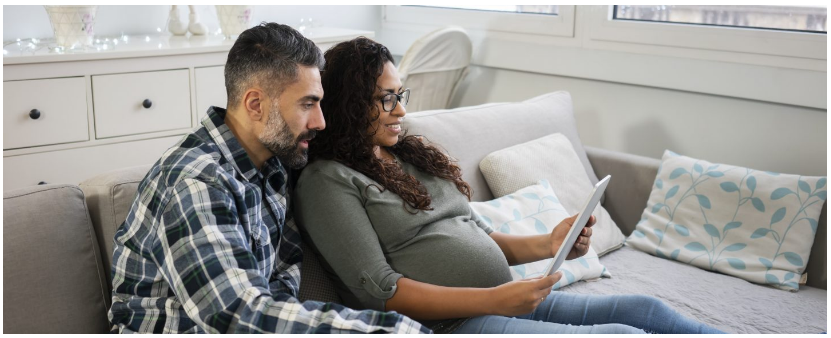

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Annuities are financial products that could help provide steady income in retirement. But an annuity can be a complex creature. Here's an overview of how annuities work, their pros and cons, and how annuities compare with IRAs.

What is an annuity?

An annuity is a long-term financial contract that can provide you with a stream of payments later in return for an investment now. Annuities can help with retirement income, estate planning or tax deferral.

There are three main arguments for buying an annuity:

There are three main arguments for buying an annuity:

- **Retirement income:** You might need more than Social Security to live on in retirement. An annuity can provide steady income so you don't outlive your savings.
- **Estate planning:** Annuities can provide income to your beneficiaries if you die, and in some cases, without going through probate.
- **Tax deferral:** You don't pay taxes on investment gains in an annuity until you withdraw the money.

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How much does a $100,000 annuity pay per month?

The amount of your annuity payment depends on factors such as how much you invest, how long you receive payments and how much your investment grows before you start getting payments.

Typically, the longer you wait to receive payments, the more time your investment has to grow, and the larger your payouts might be.

Generally, the longer you choose to receive payments, the smaller each check will be.

Inflation could make what seems like a lot of money now feel like a small amount later. A payout of $1,000 per month probably goes further today than it will 15 years from now.

How do annuities work?

Annuities can be complex, but here's an overview of some characteristics to know.

The annuity life cycle

Typically, there are two stages to annuity investments.

1. **Accumulation.** You contribute a lump sum of money or make a series of payments to the annuity provider. Whether and how that money is invested while you wait to begin taking payments depends on the type of annuity you buy. This phase could be very short or last decades.
2. **Annuitization.** The payout phase starts when you begin getting checks. You might opt for a lump-sum payment, though often people choose to receive a regular monthly payment.

Annuity types

There are several kinds of annuities. Here are some common ones.

- **Immediate annuity:** An annuity that begins paying out right away.
- **Deferred annuity:** An annuity that begins paying out later. You may get bigger payouts this way because your money has more time to accumulate investment gains.
- **Fixed annuity:** You pay a premium that's invested at a fixed rate. The investment grows based on a guaranteed rate of return.
- **Variable annuity:** An annuity that allows you to choose where to invest your premium, such as in mutual funds and bond funds. Depending on the provider, the annuity might provide a guaranteed minimum return and/or cap the maximum amount of growth. That means your investment returns or payments may never fall below a certain level (or go above a certain level). You could have higher earnings, but also more risk.
- **Equity-indexed annuity:** Here, the growth tracks to some degree a stock index such as the S&P 500, and you get guaranteed minimum payments (they also may be capped). You could have higher earnings, but also more risk.
- **Riders:** You can customize an annuity by purchasing riders. Riders are optional, add-on features. They vary by issuer. Some examples include living benefits, where you get guaranteed increases in your payouts at a certain time, and death benefits, where you have the annuity pay your funeral costs or pay a beneficiary.

Annuities taxes

Annuities are tax-deferred instruments, which means that typically, you pay tax on the income and/or earnings in the account only when you take money out.

Generally, if you buy an annuity with pre-tax dollars, like through your 401(k) or IRA, the payments you later receive from the annuity are taxed at regular income tax rates (not capital gains rates, which are usually lower). Annuities funded with pre-tax money are called qualified annuities.

If you buy an annuity through a Roth IRA or Roth 401(k), the income may be completely tax-free.

If you buy an annuity with money you already paid taxes on, then generally only the part of the account that is gains or earnings is taxed when you withdraw money from your annuity.

Can you lose your money in an annuity?

Yes. All investments have risks. For annuities, two primary risks are:

- **Market risk,** where the investments in your annuity lose value, leaving you with a smaller pool of money, which leaves you with smaller payments in the future.
- **Issuer risk,** where the issuer doesn't have the cash to pay out on your annuity.

Is an annuity a good investment?

Guaranteed payments are appealing if you'll be paying a large fixed expense like a mortgage in retirement or if you worry about running out of money when you get older.

Pros

- Annuities can be a way to get into a tax-deferred investment if you've already maxed out contributions to other tax-deferred accounts such as 401(k) and IRAs.
- You get a set payment you can count on.
- You can customize your annuity. You can choose an annuity that pays until you die, for example, or until you and your spouse have both died.
- You can choose an annuity with a death benefit, which lets you name beneficiaries to receive any unpaid money.

Cons

- Inflation can erode the buying power of a set payment amount over time.
- You may have limited (or no) say in annuity investments.
- You may get a set or capped return where the insurer keeps the difference if the investment returns exceed the cap.
- Fees are higher than IRA fees and carry potential "surrender charges" if you terminate your policy.
- Complexity.

Annuity fees

Be aware of the fees often associated with annuities.

- **Surrender charges.** If you withdraw money from an annuity before the agreed-upon date, you will likely have to pay a surrender charge. Surrender charges typically apply for several years after you buy an annuity.
- **Mortality and expense risk fees.** This typically runs about 1.25% of your account per year and compensates the annuity issuer for the risk it assumes under the contract; part of it also might pay a commission to the person who sold you the annuity.
- **Administrative fees.** You might be charged for record-keeping or other administrative expenses.
- **Underlying fund expenses.** You typically also pay the fees and expenses for the underlying mutual funds your account is invested in.
- **Other features.** You may pay additional fees for special features, such as a guaranteed minimum income benefit or long-term care insurance. You might also pay initial sales loads.

which are fees when you buy the product, as well as fees for transferring part of your account from one investment option to another and fees for other activities.

- **Tax penalties.** If you withdraw money from an annuity before you're 59 ½, you may have to pay a 10% tax penalty.

Annuities vs. IRAs

Annuities are one of many tools for funding retirement. But, as detailed above, they have their own pros and cons compared with other popular vehicles, such as IRAs. Here's how annuities compare with traditional individual retirement accounts in some key areas.

	Annuity	**Traditional IRA**
Max annual contribution	None	$6,000 ($7,000 if age 50 or older)
Contributions tax-deductible?	No	Yes, if you meet income and other traditional IRA requirements
Ability to control how money is invested?	Yes, but can be limited	Yes
Can you lose money?	Yes	Yes
Gains tax-deferred?	Yes	Yes
Early withdrawal penalty	Surrender fee based on contract, plus withdrawals before age 59 ½ may incur 10% tax penalty.	Withdrawals before age 59 ½ may incur 10% tax penalty (certain exceptions exist).

About the author: Tina Orem is an editor at NerdWallet. Before becoming an editor, she was NerdWallet's authority on taxes and small business. Her work has appeared in a variety of local and national outlets.
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