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Annuities

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Article Body:
Those with fixed incomes or living on their retirement savings are often looking for a safe, low risk place to invest their money. They will often turn to annuities, which are sold through insurance companies. Basically, an annuity is a contract between you and the insurance company that provided for tax-deferred earnings.

There are a number of insurance guarantees that come with annuities, including the option to "annuitize," or turn the principal into a lifetime stream of income. However, the fees are often quite high, and the earnings are taxed as ordinary income, not long-term capital gain.

The FDIC does not insure annuities, even if they are sold through a bank. The safety of your principal depends on the financial strength of the annuity provider. If the company fails, you might have $100,000 of coverage by your state's guaranty association. But these associations operate under state law, and vary on what they cover and how much they pay.

Fixed-rate annuities

With a fixed-rate annuity, you pay the insurance company a certain amount of money. The insurance company then guarantees you a certain periodic payment for the life of the annuity. This is often a way to se up a lifetime stream of income. The insurance company's goal is to invest your deposit and make more money than they have promised to pay you.

There are often higher interest rates on annuities than on CDs. But fixed-rate doesn't mean the same thing for annuities as it does for a CD. With a CD, the rate is fixed for the full term of the CD. Fixed-rate annuities do not have a maturity date. The rate is usually only guaranteed for the first year. The rate will then drop after the guaranteed period, and then be adjusted annually.

There may be penalties charged if you withdraw money during the penalty period. You may have to pay an 8% penalty if you withdraw money during the first year. After that, the penalty is usually decreased by 1% each year.

Annuities have tax-deferred features, so if you withdraw money before the age of 59 ½, you may have to pay a hefty 10% penalty to the IRS. The earnings on annuities are taxed as ordinary income by the IRS no matter how long you have invested.

Variable annuities

Variable annuities offer investors unique features, but they are quite complicated. They combine the elements of life insurance, mutual funds and tax-deferred savings planes. When you invest in a variable annuity, you select from a list of mutual funds to place your investment dollars. Your options may include balanced mutual funds, money market funds and several international funds.

Variable annuities have tax-deferred benefits, and they have income guarantees that you don't find in other investments. For example, for a fee, your variable annuity will pay a death benefit.

Let's look at how this works. You invest $100,000 in a variable annuity. In a few years, the value of the mutual funds in your account has fallen to $75,000. If this was a straight mutual fund, your heirs would only receive the $75,000. With this annuity, your beneficiaries are guaranteed the $100,000 if you pass away. If you have opted for the death benefits, the market value of the annuity may be as much as $125,000. Your beneficiaries would receive this amount.

Taxes are imposed in the same manner as for fixed-rate annuities. The earnings are taxed as ordinary income. You do not want to use the annuities inside of your 401(k) or IRA. These plans are built for accumulating money on a tax-deferred basis. You don't want to pay the higher costs of an annuity when you can invest in a mutual fund that benefits you at less tax expense.

There are instances when variables are a good fit. If you've already reached the limit on your other retirement savings vehicles, you might look into a variable annuity. You aren't limited in the amount you can invest in an annuity. Many allow you to convert your investment to an annual income stream, for a slight fee. The insurance company will guarantee that you will receive income payments for a certain period or for life.

CD-type annuities

A CD annuity is a fixed-rate annuity with a guaranteed rate that matches the penalty period. For example, you buy a five year CD annuity at 4%. If you hold the CD for five years then you will receive the 4% annually. If rates rise, you are already locked in at the lower rate.

Insurance companies developed CD annuities to help prevent insurers from making empty promises to continue to pay a high interest rate after the guaranteed period. Rates were falling, and customers were not getting what they expected. Customers began to pay a penalty to get out of the investment.

There are usually higher interest rates offered on CD annuities than on traditional CDs. The investment is tax-deferred, but if you cash out your five-year CD before the age of 59 ½, you will pay a 10% penalty on the gain to the IRS. Many contracts will allow you to take up to 10% of the balance or up to 100% of the interest annually without any insurance company penalties charged.

The surrender charges for a CD-type annuity are similar to those of fixed-rate annuities. There is no FDIC coverage on the investment. Some CD annuities have escape clauses in which the company penalty is waived if the customer allows the payments to be made over a five-year period or longer.