Deferred Annuities

What Is a Deferred Annuity?

Life insurance is used to create an estate for an individual if he or she dies too soon. A deferred annuity, however, can provide protection against the possibility that an individual will live too long and outlive his or her accumulated assets.

The term "annuity" derives from a Latin term meaning "annual" and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A "deferred" annuity is an annuity in which both the income, and any taxes due on growth inside the contract, are pushed into the future, until they are actually received by the owner.[1]

A commercial[2] deferred annuity is a special type of policy issued by an insurance company. In a typical situation, the policyowner contributes funds to the annuity. The money put into the policy is then allowed to grow for a period of time. At a future date, the policy may be "annuitized" and the accumulated funds paid out, generally through periodic payments made over either a specified period of time, or the life of an individual, or the joint lives of a couple.

Parties to an Annuity

There are four parties involved in a typical annuity.

1. **Insurance company:** This is the issuer of the annuity.
2. **Policyowner:** This is the individual or entity that contributes the funds. The policyowner typically has the right to terminate the annuity, to gift it to someone else, to withdraw funds from it, and to change the annuitant or beneficiary. Depending on the type of annuity, a policyowner may have other rights as well.
3. **Annuitant:** This is the individual whose life is used to determine the payments during annuitization. An annuity will remain in force unless terminated by the owner, or as a result of the death of the owner, or the annuitant dies.
4. **Beneficiary:** This is the individual or entity that receives any proceeds payable on the death of the annuitant or the policyowner, depending on whether the annuity is "annuitant driven" or "owner driven."

A single individual may be the policyowner, annuitant, and the beneficiary, although this is not usually recommended. More commonly, these roles are held by different individuals or entities.

[1] Under federal law, the deferral of income tax on growth inside the policy is available only to natural persons; the tax-deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation.
[2] A private annuity is an agreement between individuals, usually exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is not in the business of issuing annuities.

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Types of Deferred Annuities

There are many different ways to classify deferred annuities.

- **Method of purchase:** Annuities can be purchased with a single lump-sum of cash; such annuities are often referred to as single premium annuities. They may also be purchased with installment payments over time, either of a fixed dollar amount on a regular basis or with flexible payments.
- **When annuity payments begin:** Payments under a deferred annuity typically begin at some future time. In comparison, an "immediate" annuity, is purchased with a single premium, with annuity payments beginning one payment period (monthly, annual, etc.) later.
- **Investment options:** During the period before a policy is annuitized or completely liquidated, the funds invested by the policyowner are put to work. Depending on the type of annuity, the underlying investment vehicle will vary.

  - **Fixed annuity:** In a fixed annuity, the issuing life insurance company will guarantee a certain rate of interest, for a specified period of time, typically 1-10 years. Such annuities are useful for conservative, risk-averse individuals. The investment risk rests on the insurance company and any annuity payments are relatively predictable.
  - **Variable annuity:** A buyer of a variable annuity has the option of placing the funds in the policy in a variety of investment options. The investment risk rests largely on the policyowner. Annuity payments are linked to the value of the underlying investments, which can fluctuate up or down.
  - **Indexed annuity:** An indexed annuity is a type of fixed-rate annuity which combines a guaranteed minimum interest rate with a potential for greater growth, with returns being based on a formula related to a specific market index such as the Standard & Poor's 500 index. If the chosen index rises sufficiently during a specific period, a greater rate is credited to the policyowner's account for that period. Unlike variable annuities, where poor market performance can lead to decreased policy values, indexed annuities are structured to not lose value due to a declining stock market. However, because of surrender charges, an investor may lose principal value if an indexed annuity is surrendered early.

Payments from an Annuity

There are a number of ways that money may be withdrawn or received from a deferred annuity.

- **Lump-sum withdrawal:** A policyowner can withdraw all of the funds in an annuity in a single lump sum. Such a withdrawal is considered a surrender of the policy and the annuity ends. Depending on the policy and the length of time it has been in force, the insurance company may impose surrender charges, generally expressed as a percentage of the balance.
- **Partial withdrawal:** Many annuity policies allow an owner to withdraw a certain portion of the balance each year (usually 10% - 15%), without a surrender charge.
- **Partial annuitization:** Beginning in 2011, federal income tax law allows a portion of a nonqualified annuity contract, endowment, or life insurance contract to be annuitized while the balance is not annuitized, provided that the annuitization period is for 10 years or more, or is for the lives of one or more individuals.

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- **Life only annuity:** Regular payments are made for as long as the annuitant lives. When the annuitant dies, payments cease and no refund is made, even if the policyowner has not recovered the initial investment.
- **Life with term certain:** Regular payments are made for the life of the annuitant, or a specified number of years. If the annuitant dies before the specified term has passed, annuity payments continue to a beneficiary for the remainder of the term.
- **Joint and survivor:** Regular payments are made over the lives of two individuals. When one dies, annuity payments (or a specified portion) continue to the survivor.
- **Refund options:** Regular payments are made over the life of the annuitant. However, if the annuitant dies before the policyowner's investment has been recovered, the balance is refunded to a named beneficiary through either a lump-sump payment or continued annuity payments.
- **Specified period:** Regular payments are made for a pre-selected number of years. If the annuitant dies before the specified period has expired, payments are continued to a named beneficiary for the remaining term.
- **Specified amount:** Payments of a set amount are paid out regularly as long as there is money in the account.

Taxation of Annuity Payments

The tax treatment of payments made from an annuity will vary, depending on where in the life cycle of the annuity the payments are made. In general, the following rules apply.[1]

- **Before annuitization:** Funds withdrawn from an annuity prior to annuitization are considered to be made first from interest or other growth.[2] These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also subject to a 10% federal tax penalty, unless an exception applies. If earnings are completely withdrawn and payments are then made from the owner's initial investment, the payment is treated as a tax-free recovery of basis.
- **After annuitization:** Regular annuity payments are treated as being composed of part earnings and part return of investment. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment, all remaining payments are fully taxable as ordinary income. In some situations, if the owner is under age 59½ when payments are received, a 10% federal penalty tax may apply.
- **Estate taxes:** Any amount payable to a beneficiary under an annuity by reason of an owner's death is includible in the owner's gross estate. If an annuitant/owner receiving payments under a life-only annuity dies, no further payments are due and nothing is includible in his or her estate.

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[1] This information is based on federal law. State law may vary.
[2] Withdrawals from annuity policies entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

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Other Common Annuity Provisions

There are several standard provisions commonly found in annuity policies:

- **Bailout provision:** The bailout provision applies only to fixed annuity policies. In a fixed annuity, an insurer will typically offer a guaranteed rate of interest for a specified period of time. For any subsequent time periods, a different rate of interest will usually be offered. Under the bailout provision, generally, if a renewal interest rate is more than 1% less than that offered in the previous period, the policy owner has the option of terminating the policy without paying any insurance company surrender charges. Interest or other growth withdrawn will generally be subject to current income tax and may also be subject to the 10% penalty tax if taken before age 59½.
- **Surrender charges:** Most commercial annuities do not charge a commission when an annuity is purchased. Many, however, impose a surrender charge if withdrawals in excess of a certain amount are made, or if the policy is surrendered completely. Surrender charges can range from 0% to 10% and typically decline over time.
- **Prospectus:** Variable annuities are considered by the Securities and Exchange Commission (SEC) to be a security. The SEC requires that the purchaser of a variable annuity be given a prospectus, which provides detailed information on how the annuity works, the investment options available, the risks involved, and any expenses or charges. The SEC also requires individuals selling variable annuities to be licensed to sell securities.

Certain optional provisions may be available by paying an additional charge:

- **Guaranteed death benefit:** The guaranteed death benefit provision applies only to variable annuities. If an annuitant or owner in some contracts dies before annuity payments begin, the policy will pay the named beneficiary the greater of the investment in the policy (less any withdrawals) or the policy value on the date of death.
- **Enhanced death benefit:** Some variable annuities offer an enhanced death benefit option. This feature provides that upon the death of the annuitant or owner in some contracts, the beneficiary will receive the greater of the policy's value on the date of death, or the original principal (plus any additions) compounded at 5% per year. Other enhanced death benefits include percentage increases and highest anniversary valuation.

Seek Professional Guidance

Deferred annuities are primarily intended to be long-term investments. Because of this, and because of the complexity of many annuity policies, an individual considering the purchase of a deferred annuity should carefully consider all aspects. The guidance of appropriate tax, legal, and other advisors is highly recommended.