

Annuities working with your clients Retirement Planning

Most of your clients have heard that IRAs and employer-sponsored plans (e.g., 401(k)s) are the best ways to invest for retirement. That's true, but what if your client has maxed out their contributions to those accounts and wants to save more? An annuity may be a good investment to look into.

Get the lay of the land

An annuity is a tax-deferred investment contract. The details on how it works vary, but here's the general idea. As we all know, your client invest their money (either a lump sum or a series of contributions) with a life insurance company that sells annuities (the annuity issuer). The period when they are funding the annuity is known as the accumulation phase. In exchange for their investment, the annuity issuer promises to make payments to your client or a named beneficiary at some point in the future. The period when they are receiving payments from the annuity is known as the distribution phase. Chances are, they will start receiving payments after they retire.

Understand your client's payout options

Understanding your client's annuity payout options is very important. Keep in mind that payments are based on the claims-paying ability of the issuer. You want to be sure that the payments they will be receiving will meet their income needs during retirement. Here are some of the most common payout options:

- Your client surrenders the annuity and receives a lump-sum payment of all of the money they have accumulated.
- Your client receives payments from the annuity over a specific number of years, typically between 5 and 20. If they die before this "period certain" is up, their beneficiary will receive the remaining payments.
- Your client receives payments from the annuity for their entire lifetime. They can't outlive the payments (no matter how long they live), but there will typically be no survivor payments after they die.
- Your client combines a lifetime annuity with a period certain annuity. This means that they receive payments for the longer of their lifetime or the time period chosen. Again, if they die before the period certain is up, their beneficiary will receive the remaining payments.
- Your client elects a joint and survivor annuity so that payments last for the combined their life and another person, usually their spouse. When one of them dies, the survivor receives payments for the rest of his or her life.

When they surrender the annuity for a lump sum, their tax bill on the investment earnings will be due all in one year. The other options on this list provide them with a guaranteed stream of income. They're known as annuitization options because your client elected to spread payments over a period of years. Part of each payment is a return of their principal investment. The other part is taxable investment earnings. Your client typically will receive payments at regular intervals throughout the year (usually monthly, but sometimes quarterly or yearly). The amount of each payment depends on the amount of your client's principal investment, the particular type of annuity, the length of the payout period, and other factors.

Consider the pros and cons

An annuity can often be a great addition to your client's retirement portfolio. Here are some reasons to consider investing in an annuity:

- Your client's investment earnings are tax deferred as long as they remain in the annuity. They don't pay income tax on those earnings until they are paid out to your client.
- An annuity is free from the claims of your client's creditors in most states.
- If they die with an annuity, the accumulated value will pass to their beneficiary without having to go through probate.
- Your client's annuity can be a reliable source of retirement income, and they have some freedom to decide how they will receive that income.
- They don't have to meet income tests or other criteria to invest in an annuity.
- Your client is not subjected to an annual contribution limit, unlike IRAs and employer-sponsored plans. They can contribute as much or as little as they like in any given year.
- Your client is not required to start taking distributions from an annuity at age 70½ (the required minimum distribution age for IRAs and employer-sponsored plans). Your client can typically postpone payments until you need the income.

But annuities aren't for everyone. Here are some potential drawbacks:

- Contributions to nonqualified annuities are made with after-tax dollars and are not tax deductible.
- Once your client elects to annuitize payments, they're locked in. There's no flexibility to change their payment amount or make discretionary withdrawals over and above the payment amount.
- Your client can take money from their annuity before they start receiving payments, but the annuity issuer may impose a surrender charge if they withdraw their money within a certain number of years (e.g., seven) after their original investment.

- Your client may be subject to a 10 percent federal penalty tax (in addition to any regular income tax) if they withdraw their money from an annuity before age 59½, unless they meet one of the exceptions to this rule.
- Investment gains are taxed at ordinary income tax rates, not at the lower capital gains rate.