Annuity Basics

> *An annuity, in its simplest form, is a contract between the purchaser (or owner) and an insurance company (the issuer). The owner pays money to the issuer, and the issuer pays back that principal plus earnings to either the owner or the owner's named beneficiary later in life.*

Annuities were developed by life insurance companies to provide individuals with income during their retirement. However, they date back to the Roman Empire. The name is derived from the Latin word *annua*, meaning stipend. While annuities existed in America in some form even before the formation of the United States, the product gained widespread popularity during the Great Depression of the 1930s, when pension plans viewed insurance companies as more stable than other financial institutions.

Qualified vs. Nonqualified Annuities

Annuities can be either qualified or nonqualified.

Qualified annuities provide tax-advantaged, tax-deferred benefits similar to those offered by traditional 401(k) plans, 403(b) plans, or IRAs. As such, the contribution, withdrawal, and tax rules that apply to other tax-advantaged retirement plans also apply to qualified annuities. Earnings in a qualified annuity are tax-deferred until payments from the issuer are received. This tax deferral is one of the product's most attractive features. Over time, investments in a qualified annuity can grow substantially larger than if the same funds were invested in a taxable investment. However, withdrawals before the age of 59 1/2 incur a 10 percent penalty on the taxable portion, and all distributions are taxed at ordinary income rates.

Nonqualified annuities differ in that contributions are not tax deductible. Taxes are paid only on earnings when they are distributed, while the return of basis remains tax free.

The Four Parties in an Annuity Contract

An annuity contract involves four parties: the issuer, the owner, the annuitant, and the beneficiary.

- **Issuer**: The company that writes the annuity contract, typically an insurance company.
- **Owner**: The individual or entity that purchases the contract from the issuer.
- **Annuitant**: The individual whose life determines the timing and amount of distributable benefits.
- **Beneficiary**: The person who receives a death benefit if the annuitant dies.

Two Distinct Phases of an Annuity

An annuity has two distinct phases: the accumulation (investment) phase and the distribution phase.

During the *accumulation phase*, the owner contributes money to the annuity. Choosing this option means the annuity is deferred, as opposed to an immediate annuity where distributions start immediately. Annuities can be funded with a lump sum, known as a *single-premium annuity*, or through periodic investments over time.

During the *distribution phase*, the owner receives payments as outlined in the contract. There are two options for receiving distributions:

1. **Lump sum withdrawal:** The owner withdraws some or all the money in the contract at once.
2. **Guaranteed income (annuitization):** The owner elects to receive a guaranteed income stream for either the annuitant’s entire lifetime or a specified period. These guarantees depend on the claims-paying ability of the issuing insurance company, making the insurer’s financial position an important consideration.

The election for distribution typically occurs several years after purchasing a deferred annuity. Additionally, payments can be structured to cover both the annuitant’s life and the lifetime of another person—a structure known as a *joint and survivor annuity*.

How Are Annuity Payments Determined?

The amount the owner receives for each annuity payment depends on several factors and is ultimately determined by the issuer. Key considerations include:

- Account value—How much money is in the annuity
- Credit method—Whether earnings are credited on a fixed or variable basis
- Age at annuitization—The older the annuitant at the start of distributions, the higher the payment amount

- Distribution period—The length of time over which payments will be made

When is an Annuity Appropriate?

Annuities can be excellent tools when used properly, but they are not right for everyone.

Because contributions to nonqualified annuities are not tax-deductible, it is typically advisable to fund other tax-advantaged retirement plans first. However, a nonqualified annuity can be a strong option if you have already maximized your contributions to available retirement plans. There is no limit on how much can be invested in a nonqualified annuity, and funds within the contract grow tax-deferred until distribution.

Annuities are long-term investment vehicles. Withdrawals before age 59 1/2 typically incur early withdrawal penalties, and distributions within the first few years may also be subject to surrender charges imposed by the issuer. If you are confident you will not need the funds until at least age 59 1/2, an annuity may be worth considering as part of a disciplined retirement savings strategy. If your needs are shorter term, other options may be more suitable.

Sources:

Publication 575 (2024), Pension and Annuity Income | Internal Revenue Service

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