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CASE DESIGN INSIGHT

Annuity Basics: Types of Annuity Contracts

An annuity refers to a contract between an owner and an insurance company, where the owner deposits money into an insurance contract, and the insurance company, in return, provides an income stream. While annuities come in many varieties, they share these common benefits:

- Tax-deferred accumulation of assets for retirement
- Retirement income stream that may be guaranteed for life

Interest rates, income payouts, and guarantees are backed by the claims-paying ability of the issuing insurance company. In addition, variable investment options are subject to the volatility of market risk.

Parties to the Annuity Contract

Insurance Company	The Insurance Company issues the contract, provides contract information, allocates the money as instructed by the owners, and is responsible for the payout guarantees.
Owner	The owner makes the decisions about the annuity, including how the money should be allocated, who the annuitants and beneficiaries should be, and who receives the annuity distributions.
Annuitant	The income calculations on the annuity contract are linked to the annuitant's life expectancy. The owner and annuitant may or may not be the same person.
Beneficiary	If the annuity contract includes a death benefit, at the death of the owner or annuitant, the benefit will be payable to the beneficiary. If a beneficiary is not named on the contract, the money could end up going to the estate or fall subject to probate.

Types of Annuity Contracts

An annuity contract may be fixed or variable, immediate or deferred. Factors to consider when selecting the contract type include market risk tolerance, timeframe for when income is needed, guarantees offered within the contract, contract fees, provisions that hedge for inflation risk, contract liquidity, and the claims-paying ability of the issuing insurance company.

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Annuity Basics: Types of Annuity Contracts (continued)

Fixed Immediate Annuity

A single premium immediate annuity (SPIA) provides a fixed income stream, similar to a pension, in return for a lump-sum deposit to the insurance company. This type of income stream has been annuitized—the original principal is completely turned over to the insurance company in return for a fixed income stream that may be guaranteed for life or for a set number of years (period certain). The income stream may begin anytime within the year after the premium is received, with monthly, quarterly, semiannually, or annually payouts. The contract may be based on a single or joint life expectancy, and additional guarantees may be elected to provide income to beneficiaries in the case of an early death of the annuitant(s). The income stream in a SPIA is fixed at contract issue, though a cost of living adjustment (COLA) or consumer-priced index (CPI) election may be available to hedge for inflation.

Deferred Income Annuity

Similar to a SPIA contract, a deferred income annuity (DIA), or longevity annuity, will offer a fixed income stream in return for a lump sum of money. Income payouts for DIAs are deferred by two or more years after the contract is issued. DIAs are typically used to hedge longevity risk (outliving your income) by providing income when the owner/annuitant lives beyond life expectancy. In the event of an early death, return of principal guarantees may be available to pass the assets on to beneficiaries.

Fixed Deferred Annuity

A fixed deferred annuity provides a guaranteed minimum interest rate for the life of the contract, and may offer a higher interest rate for a set number of years (elected at contract issue). After the initial guarantee period, the insurance company will set a renewal rate that is no lower than the guaranteed minimum rate.

A variety of fixed deferred annuities are available:

- Book Value Annuities offer a declared interest rate for a specified period.
- Market Value Adjusted Annuities offer a declared rate of interest for a specified period. If there is a full or partial withdrawal of the contract value before the end of the guarantee period, an adjustment may be made (up or down) to the interest rate according to a formula comparing current rates to rates at contract issue.
- Indexed Annuities offer a varying rate of interest based on the performance of selected indices. There is no loss of principal if the indices do not perform well. The amount of interest earned may be limited by caps, declared rates, or other indexing strategies.

Variable Deferred Annuity

The value of a variable annuity contract is based on the underlying performance of the investment options chosen, including stocks, bonds, and money market instruments. Assets may be allocated into several different subaccounts, all within a single product. In addition, variable annuities provide the same tax-deferred growth with the ability to transfer assets among different subaccounts without incurring capital gains tax. Transfer limits and ownership considerations may apply.

Optional Living Benefit Riders

Many annuity contracts may offer an optional living benefit rider for an additional fee, providing principal protection, withdrawal benefits, or guaranteed income. These riders are typically found on variable deferred or deferred indexed annuity contracts, with a wide variety of features and benefits depending on the individual contract.

Death Benefit Features

Depending on the type of contract selected, death prior to annuity payout may result in beneficiaries receiving death benefit proceeds. The death benefit amount may be equal to the amount deposited into the annuity contract, less withdrawals. Additional death benefit riders may also be available. For an annuitized contract, the death benefit amount will depend on the type of guaranteed election that was selected. Death benefits are subject to ordinary income tax and can be included in estate tax valuation.

Annuity Basics: Types of Annuity Contracts (continued)

Annuity Fees

Fixed annuities do not have any explicit fees associated with the contract unless an early surrender takes place or a rider is added to the contract. Variable annuities have several different types of expenses, including investment management fees, annual insurance charges, and rider fees for living or death benefits.

Nonqualified versus Qualified Contracts

Nonqualified annuities, purchased with after-tax dollars, will grow tax-deferred until the money is withdrawn from the contract. Distributions from a nonqualified annuity contract are taxed either by an exclusion ratio or as last in, last out (LIFO). When the contract is annuitized, the distributions will be taxed with an exclusion ratio, meaning each payment will consist of a portion of taxable gains and a portion of basis. When the basis is depleted, the payments will continue at 100% taxable gains. Any non-annuitized distributions, including lifetime income benefits on most living benefit riders, are taxed as LIFO—taxable gains are pulled out before the tax-free return of basis is drawn down.

There is no IRS limit on the amount of nonqualified money that can be deposited into an annuity, though most contracts do require annuitization to begin around age 95. Additionally, in order for an annuity to have tax-deferred benefits, the owner must be a natural person or entity acting on behalf of a natural person.

Annuities may also fund IRAs and qualified plans, such as 401(k) and 403(B) plans. Qualified plans have contribution limits and restrictions, with the same preferential tax benefits of an annuity. Therefore, other benefits, such as a living benefit or death benefit features, should be considered when funding a qualified plan with an annuity. By purchasing an annuity, assets of a defined contribution IRA or qualified plan can be used to create a defined benefit or pension plan. Distributions from an IRA or qualified annuity contract are fully taxable. However, distributions and gains from an annuity purchased with a Roth IRA are tax-free.

Summary

Annuity contracts play a crucial role in retirement planning through tax-deferred investing and retirement income solutions. Product types vary greatly in features and structure. The expertise of an experienced insurance professional can assist in choosing the annuity contract that best fits a given situation.

For More Information

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