What is an annuity?

In its most general sense, an annuity is an agreement for one person or organization to pay another a stream or series of payments. Usually the term "annuity" relates to a contract between you and a life insurance company, but a charity or a trust can take the place of the insurance company.

There are many categories of annuities. They can be classified by:

- Nature of the underlying investment – *fixed* or *variable*
- Primary purpose – accumulation or pay-out (*deferred* or *immediate*)
- Nature of pay-out commitment – *fixed period*, *fixed amount*, or *lifetime*
- Tax status – *qualified* or *nonqualified*
- Premium payment arrangement – *single premium* or *flexible premium*

An annuity can be classified in several of these categories at once. For example, you might buy a nonqualified single premium deferred variable annuity.

In general, annuities have the following attractive features:

- **Tax deferral on investment earnings**
  Many investments are taxed year by year, but the investment earnings—capital gains and investment income—in annuities aren't taxable until you withdraw money. This tax deferral is also true of 401(k)s and IRAs; however, unlike these products, there are no limits on the amount you can put into an annuity. Moreover, the minimum withdrawal requirements for annuities are much more liberal than they are for 401(k)s and IRAs.

- **Protection from creditors**
  If you own an immediate annuity (that is, you are receiving money from an insurance company), generally the most that creditors can access is the payments as they're made, since the money you gave the insurance company now belongs to the company. Some state statutes and court decisions also protect some or all of the payments from those annuities. And your money in tax-favored retirement plans, such as IRAs and 401(k)s, are generally protected, whether invested in an annuity or not.

- **An array of investment options, including "floors"**
  Many annuity companies offer a variety of investment options. You can invest in a fixed annuity which would credit a specified interest rate, similar to a bank Certificate of Deposit (CD). If you buy a variable annuity, your money can be invested in stock or bond (or other) mutual funds. In recent years, annuity companies have created various types of "floors" that limit the extent of investment decline from an increasing reference point. For example, the annuity may offer a feature that guarantees your investment will never fall below its value on its most recent policy anniversary.

- **Tax-free transfers among investment options**
  In contrast to mutual funds and other investments made with "after-tax money," with annuities there are no tax consequences if you change how your funds are invested. This can be particularly valuable if you are using a strategy called "rebalancing," which is recommended by many financial advisors. Under

rebalancing, you shift your investments periodically to return them to the proportions that you determine represent the risk/return combination most appropriate for your situation.

- **Lifetime income**
  A lifetime immediate annuity converts an investment into a stream of payments that last as long as you do. In concept, the payments come from three “pockets”: Your investment, investment earnings and money from a pool of people in your group who do not live as long as actuarial tables forecast. It’s the pooling that’s unique to annuities, and it’s what enables annuity companies to be able to guarantee you a lifetime income.

- **Benefits to your heirs**
  There is a common misconception about annuities that goes like this: if you start an immediate lifetime annuity and die soon after that, the insurance company keeps all of your investment in the annuity. That can happen, but it doesn’t have to. To prevent it, buy a “guaranteed period” with the immediate annuity. A guaranteed period commits the insurance company to continue payments after you die to one or more beneficiaries you designate; the payments continue to the end of the stated guaranteed period—usually 10 or 20 years (measured from when you started receiving the annuity payments). Moreover, annuity benefits that pass to beneficiaries don’t go through probate and aren’t governed by your will.

Source: *Insurance Information Institute, Inc. (www.iii.org)*