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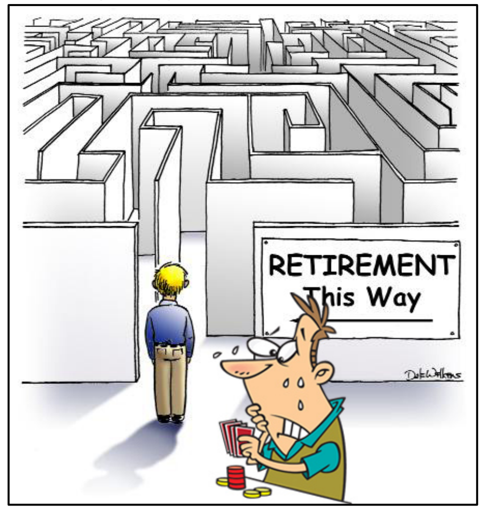
Annuities: When to hold 'em, when to fold 'em

"I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left."

- *Voltaire, French writer, historian, philosopher (1694 – 1778)*

Navigating the Retirement Maze



I've written several times in the past about annuities. Most of them are complex products, difficult to comprehend for the layperson, and come in more varieties than Baskin Robbins has flavors. To add to the confusion, many annuities have add-ons known as "riders" that provide features at an added cost.

While annuities are often viewed as a way to put the insurance agent's kids thought college, they have some features and characteristics that are not available with other financial products. Rather than review the different types of annuities, let's look at how to assess annuities you already own, determine whether they are a good fit in your financial plan, and if not, consider a way to move to a better one.

Annuity attributes

An important characteristic of annuities is that any gains are tax-deferred until withdrawn. The same is true of IRAs, workplace retirement plans (pensions, 401(k)/403(b)/457 plans), and certain types of savings bonds. Annuities usually have higher ongoing administrative costs than those other plans, paid for by the policyholder by deductions from the plan assets. Thus, if tax-deferral is your main goal, you should fund those other accounts to their maximums before acquiring or adding funds to an annuity.

Most annuities include optional the option of purchasing a number of different riders. A popular one available with most variable and fixed indexed annuities is a lifetime income rider. This provides continued income to the annuitant after the balance of the annuity is depleted. (Note: Lifetime income is an inherent property of two types of annuities: single premium immediate annuities (SPIAs) and deferred income annuities (DIAs).)

Another useful one is a cost of living adjustment (COLA) rider. Do the math on this one, because the added cost may not equal the benefit, depending upon your age, estimated life expectancy, and age at which you start taking income.

Death benefit riders are a way to leave a legacy to your beneficiaries should you die prematurely. This usually comes at a cost of receiving lower payments during your lifetime (for SPIAs and DIAs), or an ongoing fee, so consider which is more important to you. A death benefit that returns at least the premiums paid on a variable annuity (VA) may not be of much use if held at least ten years, as market returns are rarely in the red over longer time periods, even minus annuity fees.

Does the annuity fit?

Annuities are one of many financial vehicles that can add value to a financial plan. In determining the suitability of annuities that you already own, it's worthwhile to get them reviewed by an independent financial advisor who is knowledgeable about annuities and your financial situation. Better yet, do this as part of a broader financial plan to determine how well your existing annuities fit with your current and longer-term financial goals.

Annuities have annual costs for the basic product and for riders, so these all need to be examined. Compare the cost of a rider versus how it benefits your particular situation, and decide whether it's worthwhile. Rider expenses can eat away at your annuity gains (variable annuities) or add to your premiums, so choose wisely. Once purchased, a rider typically can't be removed from a policy.

If your annuity is inside of a tax-deferred plan, and you had sufficient assets in taxable accounts to fund one there, the agent who sold it to you had better have a good reason for not doing the latter. Tax-qualified plans already defer taxes until funds are withdrawn, making the tax-deferral feature of an annuity in these plans redundant. There are situations where annuities inside of qualified plans might be justified, but other than where most or all of one's assets are in retirement accounts, I've yet to come across a situation where this made sense.

Fold 'em and defer the tax

You've had your annuity reviewed, found it to be overpriced or containing features that you don't need, or lacking ones that you do. What can you do about it? Fortunately, the tax code permits a tax-free annuity-to-annuity transfer called a 1035 Exchange. If you have held your annuity for many years, the value of the holdings might be well more than what you paid into it. Cashing it out would trigger a huge tax liability at your highest tax rate. Doing a 1035 Exchange allows you to move from one annuity to a new one of similar tax status – taxable to taxable, tax-deferred to tax-deferred – that may have lower fees and more appropriate riders than your current one. This is possible for annuities that have a cash value, but not for irrevocable annuities like SPIAs or DIAs.

One caution is that if there is still a surrender charge on your existing annuity, a 1035 Exchange won't avoid it. However, most annuities issued in the last twenty years have surrender charges that go away in less than ten years, so if you have owned your annuity for longer than the surrender charge period, there is no cost to transfer to a new annuity. The process of doing a 1035 Exchange needs to comply with the tax code, so make sure to work with an insurance professional when doing one.

Like any tool in a carpenter's workshop, annuities can be useful when applied to appropriate situations. If you are using or plan to use annuities, make sure that they fit your financial needs.

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