What Is an Annuity?

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An annuity is a contract typically offered by insurance companies. It provides a regular stream of payments, guaranteeing income to the recipient over a defined period, often during one's retirement. Annuities prioritize stability over volatile growth, making them attractive to those who value financial security and a steady cash flow.

Understanding Annuities

Annuities have two distinct phases: the accumulation phase and the distribution phase.

Accumulation Phase

During the accumulation phase, you contribute funds to the annuity contract using either pre-tax or after-tax dollars.

A non-qualified annuity is funded with after-tax dollars, often with a brokerage, checking, or savings account. Contributions will not be subject to income tax, but growth within the account will be taxable upon distribution.

On the other hand, a qualified annuity is funded with pre-tax dollars, often from a Traditional Individual Retirement Account (IRA) or 401(K). Both the contributions and growth within the account will be subject to income tax upon distribution.

Note: While most annuities grow tax-deferred, there is one exception. If you funded your annuity with Roth dollars (either from a Roth IRA or Roth 401(k)) then you will **have tax-free growth and withdrawals.**

Distribution Phase

The distribution phase is when payments begin. Immediate annuities start payments within a year, while deferred annuities allow for a delay of a year or longer before beginning payments. You can also choose between a lump sum payment or periodic payments and customize the duration of the payments based on your preference, whether it's for a few years or the rest of your life.

Types of Annuities

There are three types of annuity contracts to consider, all varying in levels of risk and reward.

Fixed Annuity: A fixed annuity is a contract where the insurance company guarantees a specified rate of return on the invested funds. The insurance company takes on the investment risk and guarantees both the principal and a pre-determined interest rate. This can provide peace of mind, as you know exactly how much you will receive regardless of market fluctuations.

Variable Annuity: A variable annuity offers individuals the opportunity to invest their funds in a selection of underlying investment options, such as stocks, bonds, or mutual funds. The performance of these investments determines the value of the annuity. The return on a variable annuity is not guaranteed and is subject to market fluctuations.

If the stock market performs well, the annuity value may increase, resulting in higher potential income. Conversely, if the market experiences a downturn, the annuity value and potential income may decrease.

Indexed Annuity: An indexed annuity combines features of both fixed and variable annuities. The returns on an indexed annuity are linked to the performance of a specific market index, such as the S&P 500. However, the contract often puts a limit on how much the annuity can increase and decrease in value.

To illustrate, let's say you invest in an indexed annuity with a minimum guaranteed return of 2% and a cap rate of 7%. If the chosen market index, such as the S&P 500, performs at 10%, your annuity's return will be capped at 7%. However, if the market index performs poorly or even declines, your annuity will still provide the guaranteed minimum return of 2%.

The Bottom Line

While annuities are insurance contracts that can offer stability to risk-averse investors, they aren't suitable for everyone. Consider your risk tolerance and how an annuity aligns with your long-term financial plan. While annuities can offer a dependable source of income, it's important to note that you may be sacrificing potential returns in exchange for reliability