Why Are Annuities Important for Retirement?

By Greg DePersio AAA |

Annuities offer a unique investing tool that can provide security and peace of mind during your retirement years. Unlike stocks, bonds, mutual funds or exchange-traded funds (ETFs), annuities are sold not by stockbrokers or wire houses but by life insurance companies. Annuities are classified as a form of life insurance because they provide a death benefit. The product differs from traditional life insurance, however, in one significant fashion. Life insurance protects your family if you die too soon while annuities protect you if you live too long.

Purchasing an annuity gives you an income stream for life after you retire. Your annuity accumulates interest from the time you buy it until you turn 59.5. This is known as the accumulation phase, during which you can also add to the annuity's balance by depositing funds. Growth during this period is tax-deferred. When you turn 59.5, you may begin receiving payouts from your annuity without penalty charges. This is known as the annuitization phase, or the payout phase. Annuities offer several payout options. The most popular option is the life option, where you receive a monthly payment for the rest of your life. You also have the option to receive payments for a fixed number of years or take a lump-sum payment.

Guaranteed Income for Life

The primary way an annuity protects you during retirement is it guarantees you a monthly paycheck, similar to a salary or Social Security check, for the rest of your life. Electing the life option ensures you never outlive your annuity checks, even if you live to be 120.

With the life option, the amount of your monthly payment is calculated based on your life expectancy. Suppose the company that issued the annuity predicts you will live to be 80. Your monthly payment amount, then, is such that the balance of your annuity, principal and interest is amortized over the period from when you first begin taking distributions until you turn 80. Even if you outlive your life expectancy, the checks do not stop coming. In this regard, annuities can be very profitable for those with extraordinary longevity.

If you die before expected, you receive less of a financial benefit from your annuity. This is because your full principal and interest balance has not been returned to you before you die. Many annuity holders mitigate this risk by electing a joint-life option, which enables a surviving spouse to continue receiving the annuity payments after the holders die. The only drawback to the joint-life option is it confers a lower monthly payment than the standard life option. This is because the insurance company takes into consideration your spouse's life expectancy, not just your own, when calculating your monthly benefit amount.

While the life option, and, in particular, the joint-life option, provides the most peace of mind, you have additional options if you prefer a larger monthly check over the security of receiving one for the rest of your life. The systematic withdrawal option allows you to select the amount of time over which your annuity balance is amortized. The amount of your monthly check is based on the amortization schedule for the time period you choose. Therefore, if you start receiving payouts at 59.5 and choose a 10-year schedule, you can expect significantly larger checks versus the life option. This is because your balance is paid out in only 10 years, while the life option pays it out over closer to 20 years, assuming a life expectancy of near 80. The drawback to this option, of course, is the checks stop coming after the term you selected ends.

Yet another option you can choose is a lump-sum payment. Some, but not many, retirees choose to take a lump sum and then place it into a different investment vehicle. The reason lump-sum annuity payments lack popularity is the tax implications are brutal. Annuities do not receive the same preferential tax treatment of other investment types, such as stocks, bonds and mutual funds. Income from most investments is taxed at the capital gains tax rate, which stands at 15% as of 2015. Annuities, by contrast, are taxed at ordinary income rates, which can be as high as 39.6%, depending on which tax bracket you fall under. You are responsible for paying the entire tax on your annuity gain at the time you take a lump sum.

Fixed Vs. Variable Annuities

An additional benefit offered by certain types of annuities is a guaranteed rate of return. Fixed annuities are not tied to any economic indicators or market indexes, and they provide the same rate of return regardless of the status of the stock market or the economy as a whole. In fact, fixed annuities are not even classified as securities. The way they accumulate interest is more akin to certificates of deposit (CDs) and money market accounts, only they provide the lifetime income benefits offered by all annuities.

The only drawback to a fixed annuity is that in most cases, you accept slower growth in exchange for the security of a fixed interest rate. Variable annuities, which are tied to mutual funds and other market-based securities, pay a rate of interest that varies based on the related security. Variable annuity investors are subject to the whims of the market. Over the long term, however, variable annuities almost always provide greater growth than fixed annuities. You can decide based on your unique needs and investing sentiment whether you prefer the security of a fixed annuity or the stronger, but not guaranteed, growth of a variable annuity.

Tax Deferment

While taxes on annuity gains, depending on your tax bracket, can be higher than gains from mutual funds and other popular investments, annuities still offer the benefit of tax deferment during the accumulation phase. This means you are not responsible for paying taxes on the interest your annuity earns until you begin receiving distributions from that annuity. The ability to grow your money tax-deferred allows you to make more money over time with compound interest as opposed to if you had to surrender a portion of your gains to the government each year.

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