



Tax Deferred Annuities Explained!

Nowadays, a lot of individuals ask me for advice after being offered tax deferred annuities by their insurance agents or brokers. They come to me with a short list of positives espoused by the agent, never mentioning any negatives or slightly suggesting any hint of the complexities of these products. Since everything in the investment universe has both positives and negatives, understanding these pros and cons will lead to good decision making.

Let's take a deeper look so you can make the right decision should your advisor offer them to you.

Tax Deferred Annuity

A tax deferred annuity is an investment product offered by insurance companies where more often than not, you invest a lump-sum to receive a handful of benefits.

Here are its key features:

Tax deferral - you are only taxed when you withdraw funds, much like an IRA

Your money can be invested at a guaranteed fixed rate of interest (Fixed Annuity) or in mutual funds with returns based on market performance (Variable Annuity).

A Fixed Annuity offers CD-like fixed interest rates whose safety is backed by the insurance company.

A Variable Annuity invests in mutual funds that may contain stocks or bonds, so returns are tied to fund performance and inherently fluctuate. Your money is not guaranteed by the insurance company.

You pay penalties for the early withdrawal of earnings prior to age 59 ½ and all earnings withdrawn will be taxed at regular income rates (as opposed to much lower capital gains rates).

That was the easy stuff... let's dig a little deeper

Years ago, when capital gains and income taxes were higher, annuities were an attractive investment. You could defer your investment earnings until retirement or such time you were in a lower tax bracket and benefit from withdrawing your money at lower tax rates. Now that tax rates are lower and rates on capital gains are only 15%, annuities have become far less attractive. Many correctly question the logic of paying back 38% of their earnings in taxes instead of only 15%.

Designed to Sell

Insurance companies are in the business of creating products that agents will be able to sell to meet public demand. This may be a fine attribute for a sneaker maker or car manufacturer, but it is a dangerous idea in the investment world. It has been shown time and time again that investing in the most popular idea is a sure way to lose money. Think Internet stocks of the 90's and Real Estate in 2005. It's the same old story - when markets go down and people are scared, insurance companies bring out a slew of annuities with certain "guarantees". Guarantees which limit volatility right at the time you need "upward" volatility to recoup paper losses. When markets are hot, they bring out their most aggressive offerings to entice you to buy and reap the benefits of the current bubble.

We have now entered a time when, after 10 years of mediocre market returns and a lot of volatility, insurance companies have de-emphasized growth and focused on income. After all, no one believes in growth anymore! This new focus takes our eyes off the tax problems I mentioned above and concentrates our attention on our new, latest "worry": The fear of outliving our assets and dying penniless. Here is the new pitch: "How would you like to receive regular, guaranteed income for the rest of your life without having to worry about scary markets or dire economic conditions". Sound too good to be true? Maybe, but it's the perfect sell to a worried world.

Guaranteed Income Schemes

Since many seniors fear their nest eggs will not see them through their many years of retirement, insurance companies have now added a new feature which *seemingly* enables your wealth to grow in spite of the stock market's performance... the impossible made possible, brought to you by the geniuses at your favorite insurance company!!

These products have names like Guaranteed Minimum Income Benefit (GMIB), Guaranteed Minimum Withdrawal Benefit (GMWB).

For example, under Guaranteed Minimum Income Benefit, you invest in the company's variable annuity for a specified time, typically 10 years. If the market does not perform well, the company guarantees your investment will grow "on paper" at a rate of 5% or 6%. This is called the "base benefit" amount. Can you get this money at any time? No, it is only on paper to calculate a future income benefit when you are ready.

The insurance agent basically says, "You pay us an extra insurance premium and we will guarantee a set income to you in 5 or 10 years, even if your account value falls to zero". The mutual funds you invest in can't go to zero and the insurance company knows this – but nevertheless it imparts a certain peace of mind to the investor.

The Bottom Line

So, many pay this expensive extra premium and very few will actually receive this benefit near the end of their lives. Most will have wasted their money.

So you can see the selling cycle continues and once again, we have reacted with our emotions and made the same fatal flaw that got us to this point again and again.

Want to get the respect you deserve and actually accumulate wealth? Here's what you do. The next time things get dicey and your agent or broker tells you about a safe guaranteed investment, stop. Think. Do the opposite. Invest in stocks to take more risk. After a while when stocks rise in price-as they always do-and your agent recommends an annuity with features which enhance the growth of your stocks, stop. Think. Do the opposite. Invest in safe fixed investments.

In other words, do the exact opposite of what you feel and don't let the agent convince you otherwise. This will greatly enhance your prospects for success. It's not that hard, you just have to understand how things work and follow these simple rules.