Variable Annuities

A variable annuity is a contract between an individual (the purchaser) and an insurance company (the insurer). In return for premium payments, the insurer agrees to make periodic payments to the purchaser (if the purchaser elects this option), beginning either immediately or at some future date. Deposits can be made by either a single purchase payment or a series of purchase payments.

Purchasers of variable annuities have some control over the manner in which their annuity premiums are invested (unlike fixed annuities). The investment options (or subaccounts) of a variable annuity will usually include stocks, bonds, money market instruments, or some combination of the three. As the purchaser, you can designate how your premium dollars will be allocated among the offered investment choices.

Variable annuity features

Like all annuities, variable annuities possess a unique combination of attributes:

Tax deferral: Taxes on the income and investment gains from the annuity are deferred until money is withdrawn. Note that all distributed earnings are taxed at ordinary income tax rates and never at capital gains rates. Distributions taken before age 59½ are subject to a 10 percent early withdrawal penalty tax on earnings, unless an exception applies.

Periodic payments: Proceeds can be distributed in periodic payments for the life of the annuitant, or for the lives of the annuitant and a spouse (or some other person). If this option is elected, the annuitant cannot outlive the payment stream.

Death benefits: If an annuitant dies before reaching the annuity payout date, his or her beneficiary is generally guaranteed a death benefit. (Guarantees are subject to the claims-paying ability of the issuing insurance company.) The amount of the death benefit is usually the greater of an amount specified in the annuity contract, or the amounts contributed to the contract and the investment income credited to the contributions, reduced by any withdrawals made from the annuity. Annuity proceeds paid at the death of the annuitant will bypass probate if left to a named beneficiary.

The funds in an annuity are generally unreachable by creditors (laws vary by state).

A note about variable annuities

Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees and charges for optional benefits and riders.

Note: Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity, or from your financial professional. You should read the prospectus carefully before you invest.

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Certain riders and options relating to immediate annuities may be available for an additional fee or charge, depending on the issuer. Read the annuity's prospectus or contract for a description of the available options and associated fees and charges, if any.

The accumulation phase and the payout phase

Like other annuities, there are two phases to a variable annuity: the accumulation phase and the payout phase.

During the accumulation phase, you (as the purchaser of the annuity) make payments that are allocated to the various investment options. You can typically transfer funds from one investment option to another without paying tax on the investment income and gains.

After the accumulation phase, the funds are paid out (the payout phase). At the beginning of the payout phase, you generally elect how you want the proceeds distributed--in a lump sum, as funds are needed, or annuitized over your life, the joint life of you and another individual, or over a specific period of time.

The amount of each periodic payment you receive depends in part, of course, on how you elect to take payouts.

The death benefit

Variable annuities commonly provide a death benefit. The amount of the death benefit is specified in the annuity contract, and it may be calculated as the greater of some guaranteed minimum (e.g., all purchase payments minus withdrawals) or all the proceeds in the account at the time of death. (Guarantees are subject to the claims-paying ability of the issuing insurance company.)

Many variable annuities allow you to choose a stepped-up death benefit for an additional charge. The stepped-up benefit is a higher guaranteed death benefit, for which the insurance company charges extra premiums. The advantage of these benefits is that you will know with some certainty how much your beneficiary will receive when you die.

A number of other optional benefits can be purchased as part of a variable annuity policy to guarantee higher streams of payments. Of course, these benefits add to the cost of purchasing the annuity.

Annuity fees

Among the many major differences between mutual funds and variable annuities are the fees charged. Both mutual funds and annuities may charge a load (sales commission) plus a management fee (a fractional percentage of the total assets). The sales load can be an up-front amount to buy into the fund or a deferred sales charge (surrender charge) that is applied only on withdrawals during the initial years after purchase (usually about seven years).

Variable annuities also charge mortality fees that cover the cost of the guaranteed death benefit and the risk that annuitants receiving lifetime payouts will live longer than expected. Other annuity charges may include an administrative fee to cover record keeping and other administrative expenses. This fee may be charged as a flat account maintenance fee or as a percentage of the total account value. There may also be a fee for transferring your money from one investment option (subaccount) to another. This fee may be assessed if you exceed a given number of free transfers in a year.

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