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LIFE & ANNUITY

Everything You Need to Know About Deferred Annuities

What is an annuity?

Annuities are financial instruments that provide a stream of income in return for an upfront payment. An annuity holder pays the insurance company a premium up front and then collects regular payments to support themselves during their lifetime. This is unlike life insurance, which, in exchange for regular premium payments, provides a lump-sum payment that's intended to take care of loved ones and final expenses after the policyholder dies.

What is a deferred annuity?

There are **two types of annuities: immediate and deferred.** You can purchase an immediate annuity with a single lump-sum payment and immediately begin receiving a stream of income that lasts either for a fixed period of time or for the rest of your life.

A deferred annuity, on the other hand, can be purchased either with a single payment or a series of payments. Rather than paying the annuity holder an income stream immediately, the insurance company holds the premium payments for a period of time, during which these funds can grow in value. This phase is called the accumulation period.

What are the benefits of deferred annuities?

Compound Interest

One of the biggest benefits of a deferred annuity is that during the accumulation period, it can build **compound interest.** This gives your money more opportunity to grow as accumulated interest is added to your principal balance. While simple interest builds only on an account's original principal, compound interest builds on the total value of the account. For example,* let's say you held $50,000 in an account that returns 3% interest for ten years.

> Compound interest = principal x (1 + % interest rate)$^{\text{term of loan}}$ – principal
>
> 50,000 x 1.03^{10} – 50,000 = 17,195
>
> Simple interest = principal x % interest rate x term of loan
>
> 50,000 x .03 x 10 = 15,000

As you can see, compound interest can make a significant difference in how your money grows over time.

Possibility for Additional Payments

In some cases, deferred annuity holders are able to make additional payments during the accumulation period, even further increasing the account's earning potential. This can be a great option for people who are uncertain of the full amount they will comfortably be able to put into an annuity, since it gives them the flexibility to increase their earning power when they are able to make additional payments without penalizing them for failing to do so. For example,* using the same terms illustrated above, let's say that the annuity holder was able to make an additional payment of $2,000 one year into the contract and another additional payment of $3,000 after five years:

YEAR 1	50,000 x 1.031 – 50,000 = **1,500**
YEARS 2–5	50,000+ 1,500 + 2,000 = **53,500**
	53,500 x 1.034 – 53,500 = **6,714.25**
YEARS 6–10	53,500 + 6,714.25 + 3,000 = **63,214.25**
	63,214.25 x 1.034 – 63,214.25 = **7,993.39**
TOTAL INTEREST	1,500 + 6,714.25 + 7,993.39 = **16,207.64**

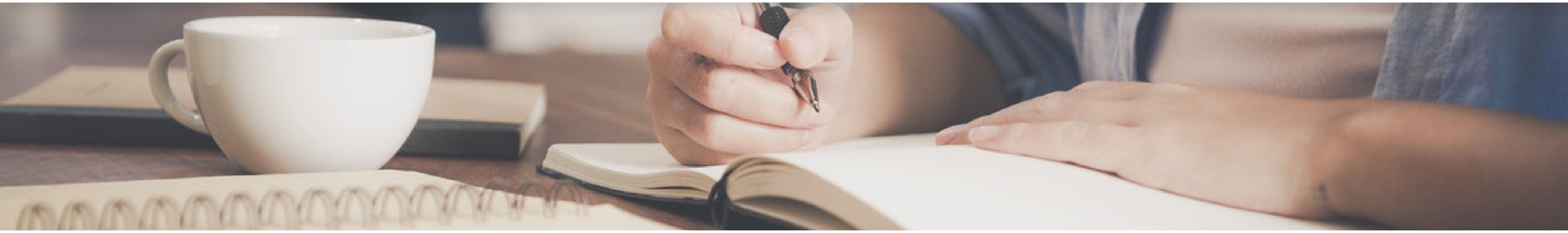
**The numbers shown are for illustration purposes only and do not represent guaranteed return on any specific product.*

Tax Deferral

Annuity holders also benefit from tax deferral during the accumulation period. This gives your money even more earning power, since more money left in the account each year to generate interest. Tax deferral gives annuity holders an edge over owners of certificates of deposit (CDs), which are generally taxed each year on the interest they earn.

Withdrawal Options

In some circumstances, deferred annuity holders are able to withdraw principal and interest ahead of the annuity's payment schedule. While doing so reduces the accounts earning power, this flexibility can be extremely valuable when unforeseen financial needs arise.



Cost of Withdrawing Money from an Annuity

Be aware that withdrawals from an annuity may cause you to incur additional costs, such as withdrawal charges or **surrender fees**. These fees tend to decline over the life of an annuity, and after a certain period of time, fee-free withdrawals may be available.

When you purchase an annuity, all fees will be spelled out in your contract terms. Enhanced withdrawal options may be available in exchange for a reduced interest rate. Be sure to Be sure to understand all terms of your annuity contract and weigh the potential benefits and cost of additional features before you sign.

Another potential cost to be aware of when considering taking a withdrawal from an annuity is the market value adjustment. This is a calculation that accounts for the interest rate that applied at the time the annuity was issued as well as the current rate. The market value adjustment generally results in additional charges on withdrawals when rates increase and, conversely, increased account value when rates decline (although this is less common).

Finally, it's important to understand that if you're under the age of 59½ at the time you take a withdrawal from an annuity, you may be subject to a 10% IRS penalty. There are exceptions to this rule, however, such as for account holders who become disabled, are called to active military service, or who experience certain types of emergencies, such as large medical bills or natural disasters. **See the IRS website for more details about exceptions to the 10% withdrawal penalty.**

What risks are involved with deferred annuities?

The main risk of purchasing a deferred annuity is that you don't know how long you will live. It's always possible that after paying into the annuity, you won't have the opportunity to enjoy the stream of income it promises. What happens in this case depends on the terms of the annuity contract, but generally speaking, the total amount paid in will be distributed to the account holder's beneficiaries. In this case, the risk is the opportunity cost of not using the money in the annuity to generate income that could be passed on.

- **Risk that owner will die during accumulation period**
  - Generally speaking, total amount paid into the annuity will be paid to **beneficiaries**
  - Details depend on **terms of contract**

How are annuities taxed?

With tax deferral during the accumulation period, taxation of annuities begins in the distribution period. In most cases, only the earnings portion of the stream of income from an annuity is subject to tax. However, if the **annuity is purchased with pre-tax money through a qualified account** such as a 401(k) or traditional IRA, then all of the money received during the distribution period is taxable as income.

Special Considerations

Before you purchase an annuity, make sure it's the right vehicle for your financial needs and goals. Annuities are designed to be held over a long period of time. If you think you'll need access to the money before the contract allows withdrawals without penalty, then another type of investment would probably be a better fit for your situation.

Annuity terms can vary greatly from one insurer to the next, so it's important to shop around to understand your range of options. Be sure to compare fees, interest rates, and withdrawal terms. Understand how funds will be distributed in case you die earlier than you expect, and use this as a basis for comparison as well.

ELCO Mutual has been providing personalized customer service to our annuity and life insurance clients since 1946. For more information, browse our **annuity offerings**, or **contact our offices.**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