



Martin Northern  
Branch Manager

# RETIREMENT INVESTING

SPECIALIZING IN INVESTMENT MANAGEMENT AND ASSET PROTECTION

August 2002

## Annuities

### The Basics

A Tax-Deferred Annuity (TDA) is a contract between you and an insurance company. In exchange for investing with the insurance company, the company agrees to pay you an income for a specified period of time, or for the rest of your life. Those payments may start at some date in the future, or they may start on the day that you make the investment.

If the payments are delayed until sometime in the future, you have what is called a *deferred annuity*. If the payments start immediately, you have an *immediate annuity*. You pay for an immediate annuity with a single lump sum of cash on the day that you make the investment. You can pay for a deferred annuity with either a single lump-sum payment, or with a series of payments made over a period of time. Your investment in the annuity will earn a return, and those earnings will grow untaxed until you begin making withdrawals. However, unless you purchase an annuity in an Individual Retirement Account (IRA), you will receive no tax deduction for any investment that you make in an annuity, but you will receive the benefit of a tax deferral on your annuity investment earnings.

### The Types

Annuities come in three types: variable, fixed, and equity-index.

**Variable Annuities:** Probably the most popular form of annuity these days, a variable annuity allows the purchaser to decide how to invest the money within a range of mutual fund type investment options offered by the insurance company. These investments are called "*sub-accounts*." They often carry the same name and are

operated by the same investment managers as publicly-offered mutual funds. They will typically offer a selection of stock, bond, and money market sub-account investments. Nevertheless, they are not the same funds because by law they cannot be.

Thus, like a mutual fund and unlike a fixed rate investment, the returns of the variable annuity fluctuate, and will vary along with the stock and bond markets. While this variability does carry a downside risk, it nevertheless affords the annuity owner the ability to participate in potentially greater returns, such as the stock market. If the stock market rises, so does the return derived from an investment in a stock sub-account. Conversely, as the market declines, so will the return. Over the long term, a variable annuity invested in a stock sub-account may provide a much better opportunity for inflation-protected income than a fixed annuity.

**Fixed Annuities:** As the name implies, a fixed annuity provides a locked-in, guaranteed rate of return on the investment, and a fixed, stable income during its payout phase. A fixed annuity thus provides a steady retirement income, but this steady return can be eroded by inflation. Options are available to have the annuity payments increase by 3 to 5 percent each year, should the investor so desire. When used, the payments with this feature would initially be lower than a fixed payment, but over the years, the payments will steadily increase at a specified rate.

**Equity-Index Annuities:** A recent innovation in the insurance industry, an equity-index annuity is a form of a fixed annuity contract tied to a stock market index that allows the investor the potential to earn returns better than those in a traditional fixed annuity, but less return and less risk than those of a direct investment in the stock market itself. The insurance company invests in a mixture of bonds and stock options designed to give a targeted participation rate on the return of a

particular stock market index, such as the S&P 500 Index. The investor is able to participate to a degree in stock market gains during a rising stock market. If the stock market falls, then the contract guarantees a minimum return, typically 3%.

In return for the minimum interest rate guarantee, the Equity-Index Annuity will limit the maximum returns of a rising stock market. Most Equity-Index Annuities use something called a “*participation rate*” in return for this guarantee. For example, the insurance company may declare a participation rate of 90%, and in some cases as low as 50%, which means that the annuity would be credited with only 90% of the gain experienced by the equity index for that year. If the stock index gained 10%, then the gain in the annuity would be credited 9% for the year.

## Annuity Taxation

One of the more attractive features of an annuity is tax-deferred growth. As long as the money remains inside an annuity, the IRS will not tax any of the earnings. A deferred annuity has two phases, *the accumulation phase* and *the distribution phase*. During the accumulation phase, the annuity grows untaxed through the years as the investment compounds. In the distribution phase, the annuity is paid out. The payment may be made as one lump sum, or as a series of scheduled payouts over a specific period or a lifetime. These series of scheduled payments are called “*annuitization*,” and the recipient is called the “*annuitant*.”

Regardless of the payment method, some income taxes will be due on every annuity payment that the annuitant receives. If the payment is made as a lump sum, then income taxes will be due on the difference between the amount paid into the annuity and its value when it is paid back.

## Taxes on a Lump-sum Distribution

For example, let's say that you have invested \$100,000 over the years into an annuity that is worth \$250,000 when you retire at age 62. If you take the \$250,000 in a lump sum, you will owe taxes on your \$150,000 gain. Fair enough, the \$150,000 is an investment gain. However, the IRS says that an

annuity gain is ordinary income, so the taxes that you will pay on that amount will be computed based on the ordinary income tax rates in effect in the year of the distribution.

## Taxes on Annuitizing

If you annuitize an annuity, part of each payment is considered a return of principal previously taxed, and part as earnings. You will owe income taxes on the part of the payment considered earnings. The amount of each payment that will not be taxed is computed by establishing an “*exclusion ratio*” that is determined by dividing your investment in the contract by the total amount that you expect to receive during the payout period. For more information about how to calculate taxes due on annuity payments, refer to *IRS Publication 939, General Rule for Pensions and Annuities*.

For example, assume that you have a fixed annuity in which you invested \$100,000 that will pay you a sum of \$750 per month for life beginning at age 62. According to the IRS life expectancy tables, you will receive those payments for 22.5 years, so your annuity contract's value is \$202,500, or 12 times \$750 times 22.5 years. Your exclusion ratio is 49.4%, or \$100,000 divided by \$202,500. Therefore, out of the \$9,000 that the annuity pays each year, you can exclude \$4,446 from the income. The remaining \$4,554 of that payment will be subject to ordinary income taxes.

## Taxes on Variable Annuities

Taxes on a variable annuity work a little differently. With a variable annuity, you do not actually know how much the annuity payment will be each month because the market value of your investment changes daily. Accordingly, the excludable amount of each annuity payment is determined by dividing your investment by the period over which you expect to receive the annuity. In the preceding example, the annuity would make a payment for 270 months, or 12 times 22.5. Therefore, if the investment was in a variable annuity, the amount to be excluded from every monthly payment would be \$370.37, or \$100,000 divided by 270. The remainder of each payment would be declared and taxed as ordinary income for that year.

## Withdrawals

A withdrawal is any amount distributed from the annuity that is not part of the annuitization process. Those payments are taxed based on when the annuity was purchased. Investments in an annuity made after August 13, 1982 are taxed on a last-in, first-out basis. That means that for income tax purposes, the first money out of the annuity will be considered as earnings, and not principal, and will be taxed as ordinary income when withdrawn from the contract. Additionally, just like a traditional IRA, withdrawals made prior to the annuitant's age 59-1/2 are subject to a 10% early withdrawal penalty.

If the annuitant dies prior to receiving any payments, then the money will go to the contract's beneficiaries. On receipt, the beneficiaries will be taxed on the earnings in the annuity at ordinary income tax rates. If the contract had been annuitized prior to the annuitant's death, then there may or may not be an income tax impact. If the annuitant opted for a life only annuity, then at death nothing passes to the heirs and no income taxes are due. If the annuitant selected a term-certain option, and died before that period elapsed, then remaining payments will be paid to the beneficiary, and the recipient will pay ordinary income tax on all earnings previously unpaid to the deceased. A joint-life annuitant, such as the surviving spouse, will continue to receive an income tax exclusion on part of the annuity payments until the entire investment in the contract is recovered.

## The Annuity That Pays It's Own Tax

Annuities work great while they are accumulating. The fixed annuity balances rise over time while variable annuities can grow at a greater rate than a fixed annuity, but they can also incur losses. Few people think about what happens at the end. You can make a lump-sum distribution and pay taxes on the gain, or if you die while the annuity is still in force, your beneficiaries pay the tax and your estate can potentially be taxed as well.

There are annuities that pay their own tax for the beneficiaries. These annuities include a provision that if the annuity owner dies after owning the annuity for at least five years, the tax on the gain, calculated at 28%, will be paid by the annuity company. This is an optional feature that has a cost of about 2/10ths of 1% annually. Be sure to request

an illustration for the exact figures. If you like the idea that an annuity can pay it's own tax bill and does not leave your heirs with a bill from the IRS, this feature could be a benefit for your family.

## *Annuity Owner's Mistakes*

I have written a booklet entitled, "*Annuity Owner's Mistakes ... What You Don't Know Can Cost You Plenty.*"

In this booklet, I point out mistakes to avoid, and to hopefully get the most out of your annuity. These potential mistakes can cost you and your beneficiaries a lot of money. You will get an education and real understanding of your annuity, in plain English. In addition, I will point out some hidden values of annuities that many people are not aware. If you would like a copy, just check the enclosed coupon.

## Now on the Web!

I have decided that this Internet thing is going to catch on. So, to do my part to kick-start this up-and-coming technology, I have published a Web page, [www.martinnorthern.com](http://www.martinnorthern.com).

Seriously, this is my first attempt at a Web page, and would value your input. What you will see in its first attempt is information about:

- My background.
- Other products and services offered by Great Nation.
- Upcoming Seminars and how to sign up.
- Previous Newsletters.

Any constructive input will be greatly appreciated. Just give me a call, or send an E-mail to [martin@martinnorthern.com](mailto:martin@martinnorthern.com).

**Fixed annuities, life insurance, and long-term care insurance are not offered by Great Nation Investment Corporation, but are offered through Martin Northern and Insurance Designers.**

Note: Investments compared to CDs and Treasury Bonds are not insured while CDs are FDIC insured and the Federal Government guarantees Treasury Bonds. Nothing herein is intended to be legal or tax advice. Readers are encouraged to consult their accountant and/or attorney. Mention of a particular investment should not be considered a recommendation. Recommendations can only be made by determining investor suitability. Past performance is not a guarantee of future results and no investment strategy can guarantee positive returns. Annuities, Mutual Funds and Church Bonds are sold by prospectus only, subject to availability. Any rates quoted herein are subject to change. The S&P 500 and Dow Jones Industrial Average are weighted, unmanaged indexes.

FOR INFORMATION  
ON THE FOLLOWING TOPICS  
RETURN THIS TO:  
Martin Northern  
Great Nation Investment Corporation  
P.O. Box 1302  
Benton, AR 72018-1302  
E-mail: martin@martinnorthern.com  
www.martinnorthern.com

Please send information on these topics mentioned in your newsletter:

- p Please contact me for a *free* Comprehensive Financial Plan.
- p Please send me a copy of your booklet, *Annuity Owner's Mistakes*.
- p Please contact me about the benefits of investing in the following annuities:
  - p Variable Annuities
  - p Fixed Annuities
  - p Equity-Index Annuities
- p Please contact me to conduct a *free* Risk Tolerance Review of my investments.
- p I would like to know more about these topics not covered in your newsletter:

---

- p I think these people would like to receive your newsletter and invitation to your next seminar.  
(Please provide their name and address with zip code):

Name \_\_\_\_\_

Address \_\_\_\_\_

Name \_\_\_\_\_

Address \_\_\_\_\_

Martin Northern  
Great Nation Investment Corp.  
P.O. Box 1302  
Benton, AR 72018-1302