# Annuities *and* Elders

"Opportunity for Tax-Deferred Growth"

"No Further Investment Decision-Making Necessary"

"Guaranteed Return"

"Eligibility for Medi-Cal for an Elder"

"Defers Income in Anticipation of a Lower Tax Bracket"

*Such features may sound enticing, but do these features actually benefit an elder?*

*an annuity is a contract*

## What is an Annuity?

An annuity is an insurance product. It is a contract with an insurance company in which the insurance company makes a series of periodic payments in exchange for money (the premium) that you pay to the insurance company. Annuities are sold by licensed insurance agents or licensed securities dealers. They are not insured by the FDIC or any other government agency and they are not guaranteed by any depository institution.

*annuities are not insured by the FDIC*

## How are Annuities Structured?

### *1. How are Payments Distributed*

**Immediate Annuity**

The insurance company distributes periodic payments to the annuitant soon after receipt of the initial premium payment. The amount of the payments is controlled not only by the initial investment and investment returns but also by the actuarial life expectancy of the annuitant.

**Deferred Annuity**

Periodic payments are distributed to the annuitant after a certain designated amount of time has elapsed, usually 15 or 20 years. Savings accumulate in the annuity investment before the payouts begin. In some respects a deferred annuity works like a certificate of deposit. Unlike CDs however, taxes on the interest earned in an annuity are deferred.

*taxes on the interest in an annuity are deferred*

### *2. What is the Rate of Return*

**Fixed Rate**

The annuity earns interest at a guaranteed specified rate of interest. Fixed annuities are invested primarily in bonds or in the insurer's general account.

**Variable Rate**

The annuity earns interest at the rate earned where the funds are invested (such as in securities like stocks, stock funds, money market accounts). The actual return varies with investment performance.

### *3. How Long are the Payments Made*

**Life**

The insurance company pays the annuitant periodic payments for as long as the annuitant lives. Many immediate annuities provide that if the annuitant dies before the end of a guaranteed period of time, payments will continue (or a lump sum will be paid) to a beneficiary. If the annuitant outlives the guarantee period, payments will continue to be made to the annuitant for his or her life.

**Term Certain**

The insurance company pays the periodic payments to the annuitant over an agreed-upon fixed term of years.

10% to 12% fee

## What Elders Should Know about Annuities

### 1. *Agent's Commission*

The selling agent typically receives a 10% to 12% fee on the gross amount of the annuity. Although the agent may suggest that the commission "does not matter" since it is paid by the insurance company issuing the annuity, the insurance company will recover the commissions by reducing the return or increasing the charges against the annuity owner.

### 2. *Annual Expenses*

Expenses do not stop with commissions. Annuities have internal expenses that can run about 2% per year which comes out of the principal of the annuity.

annuities have internal expenses

### 3. *Surrender Charges/Penalties*

If you need to cash-in the annuity before its term has matured, there may be surrender charges. Surrender charges can range anywhere from 10% to 20% of the principal. This amount is forfeited if the annuity is terminated "early". In addition, there may be early death charges (hidden surrender penalties upon death).

surrender charges can range from 10% to 20%

### 4. *Lack of Liquidity/Long Term Investment*

The purchase of an annuity is considered inappropriate for anyone over the age of 65. If a deferred annuity is purchased, it makes that money unavailable for 15-20 years (even in the case of a medical or financial emergency). An elder would need other liquid funds available to pay for any emergency.

### 5. *Tax Penalties*

The purchase of an annuity can cause severe tax penalties if IRAs or other investments are sold by an elder to purchase the annuity since this creates taxable income and possible capital gains.

### 6. *Tax Avoidance*

An elder is not taxed on the growth of the annuity until actual payouts begin and then at ordinary income tax rates. The advantage of tax deferral must be weighed against the disadvantages of having all of the deferred income taxed at once if withdrawn in a lump sum during lifetime or upon death. The fact that an elder does not receive capital gains tax treatment on capital gains but rather is taxed at ordinary income rates for capital gains within the annuity must also be considered since deferred annuities can be invested in stocks and mutual funds. Had there been direct ownership by an elder of the same stocks and mutual funds, the sale of the stocks or mutual funds would be subject to the lower long-term capital gains tax rate.

In addition, the loss of step-up in basis upon death must be taken into account. The person inheriting the annuity does not receive a step-up in basis; rather the person's basis is the same as the basis of the deceased owner.

Advantage of tax deferral must be weighed against the disadvantages of having all of the deferred income taxed at once if withdrawn in a lump sum.

### *7. Lower Income Tax Rate*

The purchase of a deferred annuity is not advisable for someone over the age of 65. Deferred annuities are purchased by people seeking to avoid taking income at today's income tax rates. These people want to defer income to a later date when they expect their tax rates will be lower. This is just not the case for many retired people. They already pay income tax at the same rate that they would expect to pay in the future.

### *8. Very Limited Medi-Cal Eligibility*

All deferred annuities are countable resources in determining Medi-Cal eligibility. Only certain immediate annuities, properly annuitized, are allowed to be an exempt resource for Medi-Cal eligibility.

*The purchase of a deferred annuity is not advisable for someone over the age of 65*

## Words to the Wise

An annuity can be appropriate if you can hold it for 15-20 years without touching it. It is a long-term investment vehicle. It may be appropriate for a "middle age" individual with a mixed investment portfolio who has a long-term investment horizon and other assets available for liquidation should an emergency arise. It is rarely considered an appropriate investment for an elder.

*Take your time*. Do not be pressured into buying any annuity product.

*Annuities contracts are very complex*. Do not sign anything you do not understand.

*Do your homework and ask questions*. Can you afford to lock up your money for a period of several years?

**Before deciding to purchase an annuity, review it with people you know and trust, such as your financial or tax advisor, your attorney or trusted family members.**

## *What to do if You Purchased an Annuity Without Being Fully Informed?*

If you feel that you have been deceived through the purchase of an annuity, you should report it to your local law enforcement, Adult Protective Services and the California Department of Insurance. Reports should also be made to the Attorney General's Public Inquiry Unit.

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| Santa Barbara City Police Department | **805-897-2300** |
| Santa Barbara County Sheriff's Department | **805-681-4100** |
| Santa Barbara County Adult Protective Services | **805-681-4550** |
| California Department of Insurance, Consumer Communications Bureau | **1-800-927-HELP (4357)** |
| TDD Number | **1-800-482-4TDD (4833)** |
| California Attorney General's Public Inquiry Unit | **1-800-952-5225** |

Complaints may also be filed online
at the Attorney General's website at

**www.ag.ca.gov/consumers/mailform.htm**

Area Agency on Aging
San Luis Obispo and Santa Barbara Counties

ELDER & DEPENDENT
Adult Abuse PREVENTION COUNCIL
of Santa Barbara County

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