What is an annuity? Here's what you need to know before buying one

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What to know before buying an annuity (Jacob Wackerhausen via Getty Images)

Annuities are a tool that can create reliable retirement income that can last as long as you do. Each annuity is a contract between you and an insurance company: You provide the company money now, and they promise to pay you a steady income later, potentially for the rest of your life.

Unlike employer-sponsored retirement plans that limit how much you can contribute each year, annuities let you invest larger sums. And while they

come with higher fees than many other retirement savings, they offer unique tax advantages that can appeal to retirees in higher tax brackets.

Found at insurance providers, brokerages and banks, annuities come in fixed or variable options, and you can get paid right away or set payouts months or years down the line.

Here’s what you need to know about annuities, how they work — and how you can choose an annuity that best fits your retirement plan and goals.

What is an annuity?

An annuity is an insurance contract between you and an insurer. For some folks, annuities are a way to ensure you don't outlive your retirement savings with income that can help pay your bills and costs, even though you aren’t working.

You can fund an annuity with a single lump-sum payment or through a series of payments over time. The insurance company then invests your money and promises to pay you back through regular installments, either right away or at a future date you choose.

These monthly installments are based on your terms. This could be for a few months, a few years or for the rest of your life, with *how much* you get every month typically depending on:

- How much money you put in
- Your age and life expectancy when payments begin
- Whether you want payments for a set period or for life
- The type of annuity you choose — fixed, variable or indexed
- Current interest rates

- Whether you want payments just for yourself or to continue to a spouse
- Extra features you add to the annuity contract

How do annuities work?

An annuity has two crucial stages: the *accumulation phase,* when your money grows tax-deferred, and the *payout phase,* when you receive income. Here's how each phase works to provide you retirement income.

Accumulation phase

During the accumulation phase, you build up money in your annuity through either a single payment or multiple payments over time. Your money grows tax-deferred during this period — as in, you won't owe taxes on any interest or earnings until you start receiving payments.

The length of this phase varies based on whether you choose an immediate or deferred annuity. With immediate annuities, the accumulation phase lasts less than a year. With deferred annuities, this phase continues for as long as you choose to delay payments.

Payout phase

The payout phase begins when your annuity starts making regular payments to you. Your payment amount depends on the total money accumulated, current interest rates, your age when payments begin and the payout options you select.

You choose whether you want payments for a specific period or for your lifetime. You can also choose whether payments should continue to a spouse or partner after your death. These choices affect your payment amounts — when you receive more guaranteed payments over a longer term, you typically receive lower monthly payments.

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Types of annuities

Annuities come in several varieties to match different retirement goals and risk tolerances. Each type offers distinct features and potential benefits, though they also carry their own set of risks and costs.

Fixed annuities

A fixed annuity provides guaranteed payments that won't change over time. These income annuities have current interest rates and a minimum guaranteed interest rate, which means your insurance company guarantees you a certain amount.

You can use the minimum guarantee to figure out how much you'll receive — at the very least — per month when it comes time to start receiving annuity payments. For example, a $100,000 fixed annuity with a guaranteed 5.00% APY would generate about $5,000 in interest the first year.

Variable annuities

Variable annuities link your payments to investment performance. Your money goes into subaccounts similar to mutual funds that invest in stocks, bonds and other securities. When these investments perform well, your payments increase. However, when investments decline, your payments decrease.

Variable annuities typically charge higher fees than fixed annuities due to the added complexity and investment management costs. Despite higher costs, variable annuities can appeal to people willing to accept some investment risk in exchange for more growth potential.

Indexed annuities

Indexed annuities tie your returns to a market index like the S&P 500, providing market exposure while protecting you from potential losses. When the index rises, you receive a portion of the gains. When it falls, you still receive minimum guaranteed payments. That's why indexed annuities are a type of fixed annuity.

Most indexed annuities limit your potential gains and losses in a straightforward way. When markets rise, you receive a portion of the gains. For example, you may receive 70% of the index returns with a maximum cap of 10%. When markets fall, you won't lose money, and your annuity typically guarantees a minimum rate of return — for example, 2% or 3%.

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When do annuity payments begin?

When it comes to payments, you can choose between immediate and deferred annuities. Each option serves different needs, whether you want to begin receiving income now or want to build larger payments for the future.

Immediate annuities

Immediate annuities start paying you from one month to 12 months after purchase. They convert your lump sum into guaranteed monthly income almost right away. You use these annuities to create predictable income that you can count on alongside Social Security and other retirement funds.

Immediate annuities can be fixed, variable or indexed. However, starting your payments soon after purchase means that you have less time to build up your returns, so your monthly payments are typically smaller than deferred annuities.

For example, a 70-year-old investing $100,000 in an immediate annuity today might receive:

- $600 to $800 in monthly payments for life
- $7,200 to $9,600 in total annual income
- Payments one month after purchase

Deferred annuities

Deferred annuities postpone payments until a future date you select. The earlier you buy your annuity and the longer you defer, the more interest it builds. This allows you to have higher monthly payments when it comes time to cash out your annuity.

Deferred annuities can also be fixed, variable or index. Since they have more time to grow, your monthly payments tend to be higher than immediate annuities.

For example, a 60-year-old putting $100,000 into a deferred annuity might receive:

- $1,000 to $1,200 in monthly payments for life
- $12,000 to $14,400 in total annual income
- Payments 10 years after purchase

Keep in mind that during the waiting period, your money grows tax-deferred. However, you begin paying taxes once your payments begin.

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What are the tax advantages of annuities?

An annuity provides tax-deferred growth on the funds you add to it. This means you won't pay annual taxes on dividends, interest or capital gains that build up inside your annuity. However, when you start receiving payments, you'll need to pay ordinary income tax based on whether you purchased a qualified or nonqualified annuity.

Qualified annuities

Qualified annuities use pre-tax dollars, typically from traditional 401(k)s or IRAs. Since you haven't paid taxes on this money yet, 100% of your annuity payments count as ordinary income for tax purposes.

Since you fund qualified annuities with pre-tax dollars, you must wait until 59 1/2 to receive payments without incurring penalties. Withdrawals before age 59 1/2 come with a 10% early withdrawal penalty plus regular income taxes.

Keep in mind that the IRS requires you to start taking required minimum distributions (RMDs) from many traditional retirement accounts at age 73. This includes traditional 401(k)s and traditional IRAs, along with any qualified annuities they may contain.

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Non-qualified annuities

Non-qualified annuities use after-tax dollars — money you've already paid taxes on through standard income tax. Payments from these annuities consist of two parts:

- **Return of your original investment,** which isn't taxed again
- **Earnings your money generated,** which gets taxed as ordinary income

Your annuity provider calculates an "exclusion ratio" for your payments. This

ratio determines how much of each payment comes from your original after-tax investment versus how much comes from taxable earnings. For example, if your exclusion ratio is 75%, then $750 of every $1,000 payment would be tax-free return of principal, while $250 would be taxable earnings.

Just like qualified annuities, withdrawals before age 59 1/2 face penalties. The 10% early withdrawal penalty applies only to the earnings portion of early withdrawals, not to the return of your original investment.

However, nonqualified annuities provide more flexibility than qualified ones since they don't require minimum distributions at any age. You can let your money continue growing tax-deferred as long as you'd like.

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Benefits of annuities

Annuities can come with some significant benefits, including:

- **Guaranteed retirement income.** It's one way to provide your future self with a guaranteed income when you aren't working anymore. Most annuities can give you a guaranteed income for the rest of your life.

- **Tax-deferred earnings.** Annuity earnings grow tax-deferred, which means you aren’t paying taxes on what you earn until you start receiving payouts. Plus, there's no annual limit on how much you can contribute, unlike IRAs and 401(k)s.

- **Customizable features.** Annuities offer various optional benefits called riders that you can add based on your needs, like inflation protection or guaranteed minimum withdrawals.

Drawbacks of annuities

While annuities have some benefits, they also have some drawbacks, like:

- **Costly fees.** High expenses are one of the main disadvantages of annuities. And fees can add up, whether they’re administrative and management fees, customization fees, contract charges or other types of fees.

- **Complex contracts.** Annuities come with many rules and restrictions that can be difficult to understand. Misunderstanding these terms can be expensive, whether due to taxes, fees or choosing the wrong type of annuity. Working with a fiduciary financial advisor rather than an insurance agent can help you avoid steep mistakes.

- **Surrender charges.** Unlike many investments, annuities charge penalties called surrender fees if you withdraw more than allowed or cancel your contract early. These fees often start at 7% or higher and gradually decrease over 7 to 10 years.

Who are annuities best for?

Annuities can serve specific retirement goals, but they aren't right for everyone. Consider an annuity if you meet these criteria:

- **You have enough money to buy one** that can pay for your estimated retirement costs after maxing out other retirement accounts like 401(k)s and IRAs.

- **You can defer annuity payments** for enough years to maximize earning interest and don't need the money for at least five to seven years or more.

- **You've consulted a fiduciary financial advisor** who can explain your annuity options and help plan for your future.

- **You understand and accept the high fees** that come along with

annuities.

When to skip an annuity

An annuity might not be the best step for your retirement strategy if:

- **You can't commit to locking up your money** for several years.
- **You need flexibility to withdraw money** without penalties.
- **You don't have the cash on hand** to invest in them right now.

There are other less expensive ways you can save for retirement, like maxing out your 401(k) or IRA.

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What to watch for

For some folks, annuities might be a good investment. Whether you’re on the fence or committed to getting one, it’s a good idea to buy an annuity from a reliable source.

Talk to a financial planner or retirement advisor who knows about annuities or can point you toward a place where you can learn more. Avoid working exclusively with insurance agents who may earn high commissions. While annuities are regulated at federal and state levels, you could still face insurance scams, fraud or misinformation.

Avoid anyone who pressures you into buying something right away or putting money down to take advantage of a "must have" offer. Ask for a detailed breakdown of all fees, commissions and surrender charges in writing. If salespeople push you into signing documents without allowing you to read them over, that's a red flag.

Use regulating agencies like the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) for guidance. Check credentials through FINRA's BrokerCheck, and verify licenses through your state insurance commissioner's office. You can also research the insurance company's financial strength rating through a credit rating agency like AM Best before committing.

Get matched with a trusted financial advisor in 4 simple steps

How annuities compare to other investments

Annuities are one type of retirement investment, but they aren't the only one. You may want to think about other retirement options, including:

- **Tax-advantaged retirement accounts.** Maximize contributions to your 401(k) and traditional or Roth IRAs first, especially if your employer matches 401(k) contributions. These accounts offer similar tax benefits to annuities with lower fees and more investment choices.
- **High-yield passive income options.** High-yield savings accounts, certificates of deposits and Treasury bonds offer government-backed safety and steady returns on your principal.
- **Income investments.** Dividend stocks and corporate bonds can provide regular income with lower fees than annuities. While they lack guarantees and can lose value during market downturns, they offer more control over your money and potentially higher returns.

FAQs: Annuities, retirement income and your retirement savings

Here are some of the most common questions about annuities and how they can contribute to your retirement income. See other articles in our retirement planning series for additional guidance.

Is an annuity a good investment?

Annuities serve a specific purpose: providing guaranteed retirement income. They work best if you've already maxed out other retirement accounts and want additional tax-deferred growth with guaranteed payments. However, their high fees and complex rules mean they aren't right for everyone. That’s why you should consider simpler, lower-cost options like 401(k)s or IRAs first. If you already maxed out these options, annuities can be a good next step to supplement your retirement income. Talk to a fiduciary retirement advisor to plan out their role in your retirement.

What's the difference between saving and investing?

The core difference between saving and investing lies in the accessibility of your money and the risks you take with it. Saving means keeping your money in secure accounts with little to no risk of losing your principal. On the other hand, investing involves buying assets like stocks, bonds or mutual funds that can potentially earn higher returns. Learn more in our guide to saving and investing to find the best approach for your golden years.

Can you cash out an annuity?

Yes, but surrender charges make early withdrawals expensive. These fees often start around 7% and decrease yearly until they disappear after 7 to 10 years. For example, cashing out a $100,000 annuity in year one could cost $7,000 in surrender fees. You may also owe income taxes and a 10% IRS penalty if you're under age 59 1/2.

I carry debt, and I'm worried I won't have enough income in retirement. Is bankruptcy an option for retirees?

Yes, filing for bankruptcy can be an option for a fresh financial start. But rather than think of bankruptcy as your way out of low retirement savings, a

better plan is to start preparing for your future right now. Learn about savings strategies, debt-payoff methods and safeguarding your golden years in our comprehensive guide to avoiding bankruptcy in retirement.

How much does a $10,000 annuity pay per month?

Monthly payments vary significantly based on current interest rates, your age when payments begin and the type of annuity you choose. Using today's rates, a $10,000 immediate annuity for a 65-year-old might pay around $75 to $80 monthly for life. Delaying payments or investing more money would increase this amount. Consult quotes from multiple insurance companies to compare current rates and payment options.

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