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Understanding Variable Annuities

Annuities are one of the most misunderstood and complex products sold by insurance agents. While the sales literature is several pages the prospectus is an inch thick. Since most people do not read the prospectus their decision is based on what they think the insurance salesperson said. Unless he tells you that this is a product that works best only if you are sure you want to receive guaranteed income for the rest of your life, which means giving up your principal, he is not telling you the whole story.

Annuities are an ideal product for those who are willing to give up their principal for a series of lifetime payments. If you do not want to give up your principal, an annuity is not the way to go.

Annuities are very popular today because they appeal to people's fears about the markets and the economy. The appealing word for most people when being sold an annuity is **guarantee**, but what exactly is being guaranteed and what are you giving up for this guarantee?

Basically and simply this is how a variable annuity works.

- Purchase an annuity contract and invest the money into a group of mutual funds in the investment account.
- In addition to the investment account an annuity account (phantom account) is established. The annuity account value is what your annuity payments are based on when you eventually start to take annuity distributions.
- The investment account value will be a function of how the mutual funds perform after the yearly annuity expenses.
- The phantom account value will be a function of the insurance company guarantee, anywhere from 4.5% to 6%, depending on your age. *(continued on page 2)*

How Long Do I Keep My Financial Records?

What documents should I keep, how long do I hold on to them and what can I shred?

• ***Tax returns*** including supporting documentation such as canceled checks, receipts for alimony, charitable contributions, mortgage interest, retirement plan contributions and records of tax deduction taken: It is recommended that you keep these types of records for 7 years. The IRS has three years from the filing date to audit your return if it suspects an honest mistake. The three year deadline also applies if you discover a mistake in your return and you want to amend your return and file for a refund. The IRS has 6 years to challenge your return if they suspect your gross income was underreported by 25% or more. No time limit applies if you did not file a return or filed a fraudulent return.

• ***IRA contribution records***: Records of non-deductible contributions to an IRA should be kept indefinitely. When it comes time to withdrawal funds from your IRA it is recommended that you have proof that tax has already been paid on this money.

• ***Retirement statements***: These records should be kept anywhere from 1 year to indefinitely. You should keep your monthly statements until you receive the year end summary. Check to see that the year end summary matches up to your quarterly statements and then shred the quarterly statements. Year end summaries should be kept until you retire or close the account.

• ***Bank records***: You should keep these records indefinitely. Years ago you received back your cancelled checks with your monthly bank statement,, nowadays you are probably receiving digital images of your cancelled checks as part of your monthly statement. You should want to keep copies of any checks related to your taxes, business expenses, home improvements and mortgage payments.

• ***Brokerage statements***: For tax purposes you have to report any capital gains or losses each year on your tax return. *(continued on page 2)*

How Long Should I Keep My Financial Records? *(continued from page 1)*

To calculate your gain or loss you will need to know the purchase price and the sale proceeds for each security that was sold during that fiscal year. These records should be kept indefinitely in the event you need to prove the declared gain or loss for a given tax year.

• ***Bills***: These records should be kept up to 1 year to indefinitely. Most of the time bills can be shredded. It is recommended that you permanently keep records of expensive items for insurance purposes to prove their value in the event of theft or damage.

• ***Credit card receipts and statements***: You should keep these records for 45 days to 7 years. When paying by credit card, you should hold onto the individual store cash receipts and when you receive your monthly credit card bill you should review all of your monthly charges to the cash receipts that you kept for the month. At that time you can shred the individual receipts, but it is a good idea to keep store receipts for the more expensive purchases since some credit card companies offer purchase protection benefits against theft and accidental damage. Keep your monthly credit card bills to prove any tax related expenses you listed on your tax return.

• ***Paycheck stubs***: You should keep these records for 1 year. Each year when you receive your W-2 form from your employer you should confirm all of your total withholdings based on your last pay stub. If your totals don't match up contact your employer immediately and have your W-2 corrected and reissued. You can shred your paystubs and keep your copy of the W-2 form for your records.

• ***Housing records***: You should keep these records for a period of 6 years to indefinitely. When you sell your home you will be required to report a capital gain or loss on your income taxes. It will save you a lot of time if you keep organized records of the purchase price and any permanent home improvements and/or additions that you made to the home. In addition you can also account for real estate commissions and legal fees that were paid during these transactions.

Source: Marquette National Bank and Catherine Williams, President of Consumer Credit Counseling Services of Greater Chicago

Understanding Variable Annuities *(continued from page 1)*

What is the annuity account and why is it called a phantom account? It is called a phantom account because it is not the amount you can cash out of your annuity. It is the amount used to establish your series of lifetime payments. It only has meaning when you give up your principal and annuitize the insurance contract.

At some point in the future you will want to start taking monthly payments or cash in the annuity and take the cash value. This is where you have to make a decision. Do I give up my principal for a series of payments for the rest of my life, or do I take my principal? You cannot have both.

If you do not want to give up your principal then the amount of money you can take from the annuity is the value of the investment account. If you decide to take payments for the rest of your life, those payments will be based on the value of the phantom account. You give up access to your principal when you decide to annuitize.

How will the value of these two accounts grow?

The investment account will grow based on the returns of the mutual funds in the investment account after expenses. The phantom account will grow based on the guarantee of the insurance company.

If the value of the investment account is greater than the phantom account then you can cash out based on the investment account value or annuitize based on the investment account value. The probabilities of the investment account being greater than the phantom account in today's market environment, in my opinion, is small because of the annual fees charged by the insurance companies and the low return from safe and secure bonds. Typical fees of 3% to 4% eat into the investment returns and reduce the potential value of the investment account.

The phantom account is guaranteed to grow at 5% per year and then pay out 5% of the value of the phantom account when you annuitize. This sounds good as long as you understand you give up access to your principal at that point. The death benefit is equal to your original investment less any withdrawals made.

In conclusion if you are looking at annuities as a place to invest your money you can do much better investing outside an annuity. In addition to significantly lower fees, gains are subject to capital gains, whereas an annuity is regular income on gains when you take out your money. If you are looking to exchange your principal for a series of lifetime payments then annuities are appropriate for a part of your portfolio.

To be sure you understand how the annuity contract works, try answering the following questions. If you are not sure of the answers, ask your salesperson to answer the questions. I suggest you ask him to answer them in writing; after all he is being well compensated to spend some time making sure you understand what you are buying.

Questions to ask the annuity salesperson.

1. If I never plan to give up my principal how much will I be able to cash out in 10 years if the investments before expenses have zero percent return over the next 10 years?
2. If I never plan to give up my principal what guarantees do I have on the value of my principal?
3. What are the annual expenses being charged in my annuity? Do these expenses come out of my investment account?
4. If I annuitize do I still have access to my principal?
5. If I annuitize do I still have life insurance, and if so how much?
6. Is the death benefit pro-rated?
7. If I take any free withdrawals do I lose the guarantee?
8. What exactly is guaranteed?