

## Episode 133 #Ask Patti Brennan – Does an Annuity Fit Within My Financial Plan? – Edited Transcript

**Patti Brennan:** Hi, everybody. Welcome to the "Patti Brennan Show." Whether you have \$20 or \$20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Today's topic as part of the "Ask Patti Brennan" series is about annuities. Let me just come clean with all of you. I'm totally agnostic as it relates to this issue. I'm not one of those advisors who says, "We would never recommend an annuity." I'm not one of those advisors who thinks an annuity should be part of everybody's financial plan.

Because guess what? It's not necessarily true in either case. What's right for you in your situation, based on your risk tolerance, your sources of income during retirement, your cash flow, what you want for yourselves and your families, that's the most important thing.

The first thing to look at when you're considering this as an option are the threshold issues. The first question should be, do you need it? Sometimes having that mailbox money, that guaranteed stream of income that you can never outlive is important because living on interest and dividends, for example, on a portfolio may not cut it for you.

Having more to cover the essential needs that we all have might be comforting for you. It supplements what you would receive, for example, in social security.

So, do you need it? What's your cash flow in retirement going to look like? What does it look like today? What would be the implications if you took a chunk of money out of your portfolio, whether it be your retirement plan, or your non-retirement of plan? You can invest in these things using either option.

We're going to go through pros and cons of each, but that's first and foremost. How much have you accrued? What are the implications if you removed that from the portfolio? By the way, how did that make you feel? You may not turn on this tap for 10 or 20 years. It is important to understand the implications.

Let's first talk about the three types of annuities. You can get a fixed annuity, which is like a CD. You've got a fixed term, it pays interest. When it matures, you can keep it in the annuity and get whatever interest rate the company's offering at that time. That's option number one.

You can also get one of these variable annuities that, basically, is like a bunch of mutual funds in annuity contract that would be tax deferred. That may be attractive with your non-retirement money. It's tax-deferred mutual funds that could turn on a stream of income that you can never outlive.

Today we are not going to get into all the different riders that are available on these things because that gets very complicated. Some of these riders sound good, but in reality, you're paying a lot of money for them, and they don't necessarily do what you think they might do.

A fixed variable is the third type of annuity, and it is basically fixed - based on a particular index. Those types of annuities have caps and participation rates.

If someone says, "We're going to give you this type of contract," that is based on an index, you got to ask that question, "Well, OK. If the S&P 500 does 20 percent, does that mean I get 20 percent on this wonderful, guaranteed annuity?" The answer is probably no. Understand that going in.

Or plan B is "OK, it may not have a cap, but you get 10 percent of the S&P." There are certain nuances to these contracts that it's important for you to understand how they work. Again, they can be fantastic, though, especially for those people who are looking for peace of mind in that season of life.

The other consideration is do you need more growth than what these things might be able to offer you? There's costs and fees. "I believe in transparency. We charge clients fees. I know exactly what they are." In these things, you sometimes don't really know what you're paying, and boy, some of them are expensive.

It may not be in the form of an expense ratio, for example. It may be in the form of an opportunity cost. For example, those other types where you're going to get 10 percent of an index. Guess who's keeping the rest? The insurance company. That's your fee.

By the way, that might be OK, totally OK. Run the numbers. You know me. I'm going to preach it till my dying day. It's OK as long as it's OK. It's different for everybody. Just run the numbers and make sure that it's OK for you.

Again, there's a lot to be said for being able to sleep at night. That peace of mind, that confidence knowing you've got this money coming in every single month from this insurance company.

This probably won't surprise you but because it's an insurance company, it's like the banking system. You've got to make sure it's a solid company. If you're investing in something like this, something that you're not going to collect on for 20 years, you've got to make sure the company is going to be around 20 years from now.

Again, very, very important because annuities are not FDIC insured. There's no such thing as SIP insurance. None of that stuff applies to annuities. Also, the consideration would be the tax implications. Retirement plans are one thing. You put your money in. When you start taking it out, it's going to be ordinary income. You're going to pay tax on it.

With the non-retirement annuities, they're interesting because when you put the money in, if they grow or when they grow, you're not paying taxes every single year on that growth. When you start to take money out, basically it's subject to this thing, LIFO. From a tax perspective, last in, first out.

What that means is that when you start taking money out of the annuity, you're getting taxed at your tax bracket at that time.

The other thing that is an important consideration that you know before you go into this is that annuities do not receive something called a step-up in cost basis. You put \$100,000 in, you never touch it because you didn't need it, which is perfectly fine.

The beneficiary then receives the value of the contract, let's say it's now worth \$200,000. There's a \$100,000 gain on that annuity. You pass away, they're paying taxes at their tax bracket at that time. They don't get this thing called the step-up in cost basis.

If you invested in a portfolio, and if that portfolio had that same experience, \$100,000 became \$200,000, the kids would inherit the \$200,000, but they wouldn't have to pay taxes on any of the gain. They only pay taxes on the gain from that point forward depending on whatever they do with it. That's a nice little loophole that an annuity doesn't provide. Certain considerations.

A potential perk of the non-retirement annuity is, let's say you turn on the tap. You put in \$100,000, it's now worth \$200,000, there's something called an exclusion ratio. Only half of it is included in your taxable income.

The actual calculation is a little bit more nuanced because the amount that you get every month, and every year is going to be based on your age at the time. It's an actuarial calculation. I think you get the drift, not all that monthly income will be taxable to you in that particular year.

For a lot of people, they like the idea of having that regular stream of income. The fact that all of it may not be taxable is a nice perk.

Other things to consider are if you do turn on the tap, be careful about the options that you choose. For example, think about this as a pension. To simplify this, what is an annuity? Let's go back to the basics. What in the world is an annuity? The annuity is a purchase of a future stream of income. That's it.

You put in a lump sum. At some point in the future, you're going to get income for the rest of your life. If you're married, you can choose joint and survivor.

If it's important for you to leave money to beneficiaries, kids, friends, whomever, then you can choose a different option. This is why this is so important. It would be a bummer if you say, "OK, pay me this monthly income that I can never outlive," you turn on the tap. That's an irrevocable decision, kind of like a pension.

Let's say that you don't live for the 20 or 30 years that you hoped to live. Well, you collect for one year, that \$200,000 evaporates. It goes back to the insurance company.

Be very careful what option you choose when you start thinking about receiving that guaranteed income. That choice is irrevocable, and it could have significant implications on the surviving spouse as well as your estate planning and what you end up leaving to the kids.

That's a brief overview of annuities and things to consider. Remember, there are three types. Contracts are crazy complicated. Make sure that somebody's getting into the weeds so that the advisor understands what exactly they're recommending. I've got to tell you, a lot of times they don't, or they forget.

I will tell you that we must keep track of it because they're always changing, so we have a database of the different types of contracts that clients have. They all have their, "If this, then that," their nuances, their rules. If you break their rules, forget it. All bets are off.

Three types of annuities. These things can be wonderful for certain people, and they may not be appropriate for other people. I will tell you the one bias I do have. I'm just going to come clean. The one bias I have is don't let anybody recommend, I would say, a third of

your portfolio into this type of contract because once it's there, you can't really get it back out again.

Sometimes life happens, and you might need that money. Be very careful. It may sound phenomenal. Gosh, I've heard people pitch in this stuff. Even I want this." The pitches are phenomenal, just be very careful. Understand that they are sold, not bought. Understand that sometimes there is a conflict of interest in all of that.

With that in mind, I want to thank you for tuning in today, listening to this wonderful, boring subject called annuities. They can be appropriate in the right situation. If you have any questions, go to our website, [keyfinancialinc.com](http://keyfinancialinc.com).

Thank you so much for tuning in today. Thanks so much for your ideas on what you'd like to hear about in the Ask Patti Brennan series. Have a terrific day.