The Hidden Costs of Annuities

The Motley Fool

Assets invested in variable annuities have been growing at a faster rate recently than those in mutual funds. Unfortunately, many people are investing in annuities without understanding them. Here are some things you should know:

- It's true that you can invest in variable annuities on a tax-deferred basis and then have the annuity regularly kick out income to you. But you can invest tax-deferred money in 401(k)s and IRAs, as well, often at a lower cost. You can withdraw money from IRAs, 401(k)s, and regular brokerage accounts, too, simply by regularly selling some of your holdings.
- When you're eventually taxed on annuity earnings, it'll be at your ordinary income tax rate, which can be as high as 39.6%. The regular long-term capital gains rate is just 20%.
- Annual fees for variable annuities are typically between 2% and 3%. If your annuity is worth $100,000 and you're paying 2.5% in fees, you'll be forking over $2,500 per year. (Ouch!)
- When you buy into an annuity, be prepared to stick it out, or get stuck. Those who withdraw their money within the first few years often have to pay "surrender" fees of 6% to 9%. On $100,000, that could be as much as $9,000. This fee exists partly to compensate the person who sold you the annuity, who often gets a commission of between 5% and 8%.
- Withdraw funds from an annuity before you're 59 1/2 and you'll face a 10% penalty.
- If you don't withdraw annuity money before you die, your beneficiaries will be taxed on it. Mutual funds and individual stocks will cost your heirs much less.
- The so-called "death benefit" is not as exciting as it seems. (The fact that you have to be dead to receive it also detracts from its appeal.) It generally costs more than it's worth and will often just pay out what you put into the annuity.