

FINANCIAL FOUNDATION PRODUCT SERIES

Comparing Tax-deferred Annuities vs. Certificates of Deposit (CDs)

By Insurance Insight Group, Inc.



One of the basic questions that should be asked is how to compare a tax-deferred annuity to a certificate of deposit. While both are financial foundation products that are purchased as safe money solutions they have fundamental differences that need to be addressed as they complete their financial planning.

Which product is the right choice?

In different situations both can be the right choice. When it comes to your needs, it is important to determine whether you need ready access to your money for short-term goals or need to put funds away for longer-term goals.

Safe money is the money you don't want to take the chance of losing. Both annuities and CDs are great safe money places for your nest egg dollars. When it comes to which one is better, the answer depends on your individual financial situation and objectives. This white paper offers a snapshot of the characteristics and differences of each type of product.

Certificates of Deposit (CDs)

A CD is a type of savings account found at banks and credit unions that offers interest rates locked in for a specific period of time.

CDs attract individuals who are looking for a safe place for their money. These people usually value the return OF their money more than the return ON their money. Most CDs are issued by a bank or credit union and guaranteed by the Federal Deposit Insurance Corporation (FDIC) (www.fdic.gov/) or National Credit Union Administration (NCUA).

CDs typically range in duration from 3 months to 5 years and guarantee a specific interest rate for the

term chosen. Generally, the shorter the duration, the lower the interest rate. The typical time period selected is 1-3 years, and interest rates will differ depending on market conditions when the CD is purchased. At maturity, owners must decide whether to accept a new guaranteed interest rate and duration period or move the money. If no action is taken, the financial institution will automatically renew the CD for the same duration and lock in the interest rate in effect at that time.

If the purchaser of the CD looks to withdraw the money prior to the agreed maturity date the bank will usually impose an early withdrawal charge of a minimum of 6 months interest or greater.

Annuities Are:

- ▶ Not A Bank or Credit Union Deposit Obligation
- ▶ Not FDIC Or NCUA Insured
- ▶ Not Insured By Any Federal Agency
- ▶ Not Guaranteed By Any Bank or Credit Union

Tax-deferred annuities

An annuity is an insurance product you can use to accumulate funds for retirement and other long-term objectives. It is a contract between the purchaser and the insurance company where money is paid to the insurance company now in exchange for a lump sum or income payments at a later time. Earnings on money held in a deferred annuity are not taxed until withdrawn.

An annuity is not insured by any government agency; rather, annuity guarantees are based on the financial strength and claims-paying ability of the insurance company. Financial strength ratings issued by independent reviewers as well as the annuity's features play an important role in the selection of one contract over another.

Most annuities are designed with withdrawal charges and accumulation strategies that range between 5 and 12 years in duration. Some may have rate guarantees that extend beyond the first contract year, while others offer attractive first-year interest rates with renewal rates that change annually in years two and beyond. These renewal rates will never fall below the minimum guaranteed interest rate declared in the annuity

contract, and many annuities can have renewal rates that are higher than the minimum guarantee.

Unlike CDs, annuities usually allow for free withdrawals of a portion of the contract value after the first year. (Note: withdrawals may be taxable and excess withdrawals may incur withdrawal charges.)

Another benefit for most annuity owners is the potential to avoid the costs, delays and publicity of probate, as death benefit proceeds are passed directly to the named beneficiary.

Short-term or long-term goals

The key factor in the decision to purchase an annuity or CD should be whether the money is intended for short-term or longer-term goals.

CDs are generally considered short-term vehicles and are used for such goals as saving money for a new car or a down payment on a house. CDs work well for these goals due to their short time periods.

Annuities are typically chosen with the intention of holding the contracts for longer periods of time. They are generally used to help save for retirement or protect money that has already been accumulated for long-term goals. Although annuities are considered long-term vehicles, once the withdrawal period has been satisfied, they are free of any new withdrawal charges and can provide liquidity as needed.

The tax difference

While the length of the duration period is a key factor, it's easy to see the biggest difference between the two products comes down to taxation. Earnings on CDs are taxed annually. With an annuity, interest earnings are not taxed until withdrawn.

Unless the CD is held in a qualified account (such as an IRA), interest earnings in a CD are reported annually and income tax must be paid on the earnings each year, even if funds are not withdrawn from the account. Interest earnings in an annuity are taxed during the year they are withdrawn and subject to your income tax rate at that time.

It may seem like a simple point, but the difference between a tax-deferred product and a taxable product can be considerable. Money can grow faster in a tax-deferred product like an annuity because interest compounds on top of the money ordinarily paid in

current income taxes. A tax-deferred product may outperform a taxable one because there are three components at work:

- ▶ The premiums earn interest
- ▶ The earnings on the premiums earn interest
- ▶ And most importantly, the money you are not paying in current taxes earns interest.

Assume you have \$100,000, you are in a 28% Federal tax bracket and you are considering the purchase of a CD or a tax-deferred annuity. The following is a comparison of the growth in each product over a 20-year timeframe. In this example, the CD and annuity both assume the same rate of return (5% before-tax yield) over 20 years and annual compounding. After 20 years, the CD's value is \$202,859 and the annuity's value after taxes is \$219,037.*

*Hypothetical projection is based on a 5% return over the life of each product and is not guaranteed. Assumes no withdrawals. Actual value may be higher or lower than indicated. The interest earned on the annuity at time of withdrawal may place you in a higher tax bracket. If this happens, the annuity's value after taxes may be lower than indicated. Annuities contain limitations. Charges for early withdrawals and tax penalties may apply.

Access to your money

The way money is paid out from these products is also an important factor to consider. At the end of an annuity's accumulation or growth period, an owner can opt to keep the money in the annuity for continued growth, take a lump sum amount, or chose to take income over a selected time period.

With a CD, the owner can take a lump sum distribution, renew the CD at a current or promotional renewal interest rate or look at other accumulation alternatives. CD renewal rates are not guaranteed at the time of the original transaction and there are no income options available.

Are annuities right for you?

- ▶ Do you have longer-term goals for this money?
- ▶ Will tax-deferred products make a difference in your portfolio?
- ▶ Are you concerned with outliving your retirement income?

If you answered "yes" to any of these questions, an annuity may be a possible choice. Annuities are long-term insurance products that provide the advantages of tax deferral and give the option to provide an income that you can't outlive.

Comparison of Tax-Deferred Fixed Annuities and CDs

- Free from principal/market risk and price fluctuations
- Interest earnings free from current taxation
- Interest earnings reinvested automatically with no current income taxation
- Triple compounding without taxation (i.e. interest on principal; interest on interest; interest on tax deferred money)
- Reduces or eliminates taxes on Social Security income
- FDIC insurance
- Partial withdrawals available without penalty
- Potential to avoid the costs, delays and publicity of probate
- Guaranteed lifetime income with tax advantages

ANNUITY	CD
✓	✓
✓	
✓	
✓	
✓	
	✓
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✓	

This white paper has been prepared as general information on the topic of tax-deferred annuities and CDs. It is intended to be an overview and not to serve as a comprehensive analysis of these two types of financial products. Neither the company nor its sales representatives can give tax or legal advice. Please consult your attorney and/or tax advisor regarding your specific situation.

These are just a few of the reasons to consider if an annuity or a CD is right for you. Because you care about financial products that are guaranteed by the financial strength of the company you do business with, you look for a strong, stable insurance company you can depend on.

This is a white paper prepared for the Financial Foundation Product Series. Financial Foundation Products are those products that consumers should likely own as they provide benefits that are essential to developing a solid individual financial plan.