What Is the Difference Between a Fixed Annuity and a Variable Annuity?

An annuity is a contract with an insurance company in which you make one or more payments in exchange for a future income stream in retirement. The funds in an annuity accumulate tax deferred, regardless of which type you select. Because you do not have to pay taxes on any growth in your annuity until it is withdrawn, this financial vehicle has become an attractive way to accumulate funds for retirement.

Annuities can be immediate or deferred, and they can provide fixed returns or variable returns.

Fixed Annuity

A fixed annuity is an insurance-based contract that can be funded either with a lump sum or through regular payments over time. In exchange, the insurance company will pay an income that can last for a specific period of time or for life.

Fixed annuity contracts are issued with guaranteed minimum interest rates. Although the rate may be adjusted, it should never fall below a guaranteed minimum rate specified in the contract. This guaranteed rate acts as a “floor” to potentially protect a contract owner from periods of low interest rates.

Fixed annuities provide an option for an income stream that could last a lifetime. The guarantees of fixed annuity contracts are contingent on the financial strength and claims-paying ability of the issuing insurance company.

Immediate Fixed Annuity

Typically, an immediate annuity is funded with a lump-sum premium to the insurance company, and payments begin within 30 days or can be deferred up to 12 months. Payments can be paid monthly, quarterly, annually, or semi-annually for a guaranteed period of time or for life, whichever is specified in the contract. Only the interest portion of each payment is considered taxable income. The rest is considered a return of principal and is free of income taxes.

Deferred Fixed Annuity

With a deferred annuity, you make regular premium payments to an insurance company over a period of time and allow the funds to build and earn interest during the accumulation phase. By postponing taxes while your funds accumulate, you keep more of your money working and growing for you instead of paying current taxes. This means an annuity may help you accumulate more over the long term than a taxable investment. Any earnings are not taxed until they are withdrawn, at which time they are considered ordinary income.

Variable Annuity

A variable annuity is a contract that provides fluctuating (variable) rather than fixed returns. The key feature of a variable annuity is that you can control how your premiums are invested by the insurance company. Thus, you decide how much risk you want to take and you also bear the investment risk.

Most variable annuity contracts offer a variety of professionally managed portfolios called “subaccounts” (or investment options) that invest in stocks, bonds, and money market instruments, as well as balanced investments. Some of your contributions can be placed in an account that offers a fixed rate of return. Your premiums will be allocated among the subaccounts that you select.

Unlike a fixed annuity, which pays a fixed rate of return, the value of a variable annuity contract is based on the performance of the investment subaccounts that you select. These subaccounts fluctuate in value with market conditions and the principal may be worth more or less than the original cost when surrendered.

Variable annuities provide the dual advantages of investment flexibility and the potential for tax deferral. The taxes on all interest, dividends, and capital gains are deferred until withdrawals are made.

When you decide to receive income from your annuity, you can choose a lump sum, a fixed payout, or a variable payout. The earnings portion of the annuity will be subject to ordinary income taxes when you begin receiving income.

Annuity withdrawals are taxed as ordinary income and may be subject to surrender charges plus a 10% federal income tax penalty if made prior to age 59½. Surrender charges may also apply during the contract’s early years.

Annuities have contract limitations, fees, and charges, which can include mortality and expense risk charges, sales and surrender charges, investment management fees, administrative fees, and charges for optional benefits. Annuities are not guaranteed by the FDIC or any other government agency; they are not deposits of, nor are they guaranteed or endorsed by, any bank or savings association. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing insurance company.

Variable annuities are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity contract and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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