

Retirement changes the direction of money. During the working years, income arrives first and bills are paid from it. After employment ends, the bills continue arriving, but the paycheck may no longer be there to meet them. Savings can replace part of that paycheck, although savings do not naturally arrive in equal monthly amounts and cannot promise to last through an unknown lifetime. An annuity is designed to address that uncertainty by allowing someone to exchange money today for an insurance company's contractual promise of income now or later. The central value is not merely earning a return; it is creating a payment that can continue even when the person lives far longer than expected.

An annuity is a contract between an individual and an insurance company. The individual pays one premium, several premiums, or transfers money from another eligible account. In return, the insurer provides benefits described in the contract, which may include tax-deferred growth, future withdrawals, a death benefit, or income lasting for a specified period or for life. The contract—not a salesperson's illustration, brochure, or verbal promise—controls what the owner is entitled to receive. Annuities can differ so greatly that the word alone does not reveal the cost, risk, liquidity, return, or income.

[Investor.gov explains the contract structure and the major categories of annuities.](#)

The person who owns the contract is called the owner. The annuitant is the person whose life expectancy may be used to calculate lifetime payments, and the beneficiary is the person designated to receive an applicable death benefit. One individual can fill all three roles, but the roles can also be divided. Confusion among them can create tax, control, and inheritance problems because the owner controls the contract while the annuitant's life may determine when payments stop. The beneficiary does not necessarily inherit a continuing stream of lifetime payments; the contract's death-benefit provisions settle what remains. Names, relationships, and successor arrangements should be reviewed before the contract is issued.

An annuity usually moves through an accumulation phase and a payout phase. During accumulation, premiums enter the contract and may earn interest or investment returns under its rules. During payout, the contract sends money back through withdrawals, scheduled payments, or annuitization. Annuitization means converting some or all of the contract's value into a formal stream of payments based on the selected period and lives covered. Once annuitization is completed, the decision is often permanent, and the owner may no longer possess an accessible account balance connected with the amount converted. The insurer has taken responsibility for making the promised payments under the chosen form.

An immediate annuity has a short distance between the premium and the first payment. Someone may give an insurer a single amount at retirement and begin receiving income within a year, often within a month. A deferred annuity leaves time between purchase and income, allowing the contract to accumulate before payments begin. A fifty-year-old might purchase a deferred contract for income at sixty-five, while a seventy-year-old

might buy an immediate contract to create income now. “Immediate” and “deferred” describe timing, not the investment method. Either structure must still reveal whether growth and benefits are fixed, indexed, variable, or built from another permitted design.

An immediate income annuity is easiest to understand by watching a retirement balance change form. Suppose a sixty-seven-year-old transfers \$200,000 to an insurer and selects a lifetime payment. The company studies age, interest rates, expected longevity, expenses, and the selected survivor protections before quoting a monthly amount. If the contract promises \$1,200 per month for life, the retiree receives \$14,400 each year regardless of whether life continues for five years or thirty-five years. The \$200,000 is no longer being managed as an ordinary personal investment account after full annuitization. It has been exchanged for the insurer’s commitment to keep sending the contractual payment.

Lifetime income is possible because the insurer pools many people together. Some annuitants will die earlier than expected, while others will live much longer. Money no longer needed to support payments for those who die earlier helps the insurer continue paying those who survive. The additional value long-lived participants receive from this pooling is sometimes described as a mortality credit. It is not a bonus secretly added to an account; it is part of the economics that allows lifetime payments to continue. An individual investment portfolio cannot produce the same pooling effect because all remaining money still belongs to that one investor or the investor’s heirs.

The payment form determines who is protected and what is surrendered. A life-only annuity generally produces the largest monthly amount because payments stop when the annuitant dies. If death occurs shortly after purchase, the insurer may keep the unpaid balance unless the contract includes a refund or guaranteed-period feature. A joint-and-survivor annuity pays while either of two covered people remains alive, but the starting payment is lower because the insurer may be paying across two lifetimes. A period-certain option guarantees payments for at least a selected number of years, allowing a beneficiary to receive the remaining payments if the annuitant dies early. Each protection reduces the monthly income because the insurer is accepting a larger or longer obligation.

An illustrative set of quotes might offer \$1,200 per month for one life, \$1,050 for two lives, or \$980 for two lives with an annual increase. These are not market quotes; they simply show the trade being made. Selecting \$1,200 creates more income now but may leave nothing after an early death. Taking \$1,050 protects the second person, while accepting \$980 may provide room for later increases. The lower payment is not evidence that the insurer misplaced part of the premium. It represents the price of adding another life, a guaranteed period, a refund, or inflation protection to the contract.

Inflation deserves special attention because guaranteed does not necessarily mean unchanging in purchasing power. A fixed \$2,000 monthly payment will still be \$2,000 twenty years later, even if rent, food, utilities, and medical costs have become much more

expensive. Some annuities offer payments that rise by a fixed percentage or respond to an inflation measure. The starting amount is usually lower because the insurer expects to pay more later. A retiree may use a level annuity for stable essential bills while keeping other assets invested for growth, or may accept a smaller inflation-adjusted payment to protect later purchasing power. The contract solves longevity only according to the dollars it promises, not according to every future price.

A fixed deferred annuity credits interest under terms established by the insurer. The company may guarantee one rate for a specified period and then apply renewal rates later, subject to a contractual minimum. A multi-year guaranteed annuity, often called a MYGA, promises a stated rate for a particular number of years. It can resemble a bank certificate of deposit because both may quote a rate and limit early access, but they are not the same product. The annuity is an insurance-company obligation rather than an FDIC-insured bank deposit. Its taxes, surrender rules, renewal terms, and protection system operate differently from those of a CD.

The word “guaranteed” always needs a name behind it. An annuity guarantee is supported by the issuing insurance company’s financial strength and claims-paying ability. It is not ordinarily a promise from the federal government, the stock market, or the salesperson. State insurance regulators oversee insurers, and state guaranty associations may provide limited protection if an insurer fails, but limits and rules vary by state. That protection should not be used as a substitute for examining the issuing company. Financial-strength ratings, contract obligations, complaint history, and diversification among insurers can matter when a person is entrusting substantial retirement money for decades.

A fixed indexed annuity connects interest credits to the movement of an outside market index, such as the S&P 500, without placing the contract owner directly into the stocks in that index. If the index rises, the insurer calculates interest using a participation rate, cap, spread, or another contractual method. A cap is the maximum credited return, while a participation rate determines how much of an index gain is recognized. If the index rises 12% but the contract has a 6% cap, the account may receive only 6%. If a 50% participation rate applies instead, a 12% index gain may produce a 6% credit. The contract usually does not include the index’s dividends unless its formula specifically says otherwise.

The floor provides the protection people often find attractive. If the selected index falls 15% during the measurement period, a fixed indexed annuity may credit 0% rather than passing the 15% market loss into the contract value. Zero is better than a market decline, but it is still a year without credited growth. Withdrawals, surrender charges, rider fees, or contract adjustments may reduce value even when the index calculation itself does not create a loss. The insurer can also change renewal caps or participation rates within the limits of the contract. The headline “market growth without market losses” hides the restrictions that determine how much growth is actually received.

A registered index-linked annuity, usually shortened to RILA, allows more market risk than a fixed indexed annuity. Its return is connected to an index, but the owner can lose money when the index declines. A buffer might protect against the first 10% of a loss, leaving the owner responsible for any decline beyond that amount. If the index falls 18%, a 10% buffer could leave an 8% loss under a simplified example. A floor design may instead set the maximum loss the owner can experience during the term. In return for accepting some downside, the contract may offer greater upside potential than a fixed indexed annuity, although caps and participation limits can still apply.

The measurement period matters in indexed contracts. An insurer might calculate performance over one year, two years, or a longer segment. Removing money before the segment ends can eliminate an uncredited gain or cause an interim adjustment. The result visible halfway through a term may not be the result the contract uses on the official ending date. Some products offer several index strategies with different caps, buffers, participation rates, and terms, turning one annuity into a collection of separate crediting methods. Complexity is not automatically harmful, but every moving part creates another condition that must be understood. An owner should be able to explain how the contract earns money during a rising, flat, and falling market.

A variable annuity places the contract's value into investment options called subaccounts. These may resemble mutual funds and may hold stocks, bonds, or other securities, but they exist inside the insurance contract. The account rises and falls with investment performance, so principal can be lost. The insurer may offer optional guarantees involving death benefits, future income, or protected withdrawals, but those guarantees do not necessarily protect the entire accessible account value from market losses. Variable annuities are securities as well as insurance products and must provide a prospectus describing their risks, fees, and investment choices. The protection comes from specific contract provisions rather than from the word "annuity."

Variable annuity expenses can form several layers. The insurer may charge a mortality-and-expense fee for the insurance risks and contract costs it assumes. Administrative fees may pay for recordkeeping, while the underlying subaccounts charge their own investment expenses. Optional income and death-benefit riders create additional fees. A 1.25% insurance charge, 0.80% in fund expenses, and a 1% rider would consume more than 3% annually before the account produces net growth. A strong market return can hide those costs for a while, but fees continue reducing the amount available to compound.

A rider is an optional benefit attached to the basic contract. One widely used rider is a guaranteed lifetime withdrawal benefit, often shortened to GLWB. It may promise that the owner can withdraw a stated percentage for life even if the actual contract value later falls to zero through permitted withdrawals and investment performance. This sounds similar to annuitization, but the two are not identical. With a withdrawal rider, the owner often retains an accessible contract value and some beneficiary value while following the

rider's rules. Annuitization formally converts value into a payment stream and may surrender access to the amount converted.

Income riders often create a second number called an income base, benefit base, or withdrawal base. This figure is used to calculate the guaranteed withdrawal and is not necessarily cash the owner can remove. Suppose the actual contract value is \$150,000 while the income base has increased to \$200,000. If the contract permits a 5% lifetime withdrawal, the promised income may be calculated as 5% of \$200,000, producing \$10,000 per year. The owner cannot automatically cancel the contract and collect the \$200,000 income base. Surrendering the annuity would generally provide the actual contract value after applicable charges, not the accounting figure used for the rider.

The difference between those two numbers is where many misunderstandings begin. A salesperson may emphasize that the income base receives a 7% roll-up, causing the buyer to believe the entire investment is earning 7%. The roll-up may increase only the number used to calculate later income, while the accessible contract value follows a different crediting or investment method. Once lifetime withdrawals begin, the roll-up may stop, and the withdrawal percentage may depend on the owner's age. Taking more than the permitted amount can reduce or terminate the guarantee. A benefit should never be valued until the buyer knows which balance can be withdrawn, inherited, annuitized, or merely used in a formula.

Death benefits also differ from one contract to another. A basic deferred annuity may pay the beneficiary the current contract value when the owner dies before income begins. Another may guarantee at least the premiums paid, adjusted for withdrawals, while an enhanced rider may lock in certain anniversary values. Once the contract is annuitized under a life-only option, there may be no remaining death benefit. A period-certain, joint-life, or refund feature can preserve some value after death, but it generally reduces the income payment. The owner should examine death before purchase rather than assuming unused principal will automatically return to the family.

Liquidity is the price often paid for annuity benefits. Many deferred contracts impose a surrender period lasting several years. During that period, withdrawals above a permitted free amount may trigger a surrender charge. A schedule might begin at 7% and decline each year until reaching zero, although actual schedules vary. Withdrawing \$50,000 while a 6% charge applies would cost \$3,000 before taxes or other adjustments. The contract may allow 10% annual withdrawals without a surrender charge, but that feature must be confirmed rather than assumed.

Some products also use a market value adjustment, or MVA. This adjustment can increase or decrease the amount received when money is withdrawn before the end of a guaranteed term. If market interest rates have risen since the contract was issued, the adjustment may reduce the surrender value because the insurer is releasing money from an older, lower-rate arrangement. If rates have fallen, the adjustment may work in the owner's favor. An MVA is separate from the ordinary surrender charge and can create a

larger loss than the owner expected. The account's displayed value should therefore be separated from the amount actually available upon surrender.

Annuity contracts usually provide a free-look period after delivery. State law commonly gives the buyer approximately ten to thirty days to review the completed contract and cancel it, although the exact period and refund calculation vary. This is the time to compare the issued contract with every promise made during the sale. The owner should verify the premium, surrender period, interest method, income rider, beneficiaries, charges, and payout provisions. Discovering that a verbal explanation does not appear in the written contract is a reason to stop and investigate. [Investor.gov explains surrender charges, contract adjustments, exchanges, fees, and the free-look period.](#)

Annuities can be qualified or nonqualified. A qualified annuity is held inside a tax-advantaged retirement arrangement such as an IRA, 401(k), or 403(b). Because the retirement account already provides tax deferral, placing an annuity inside it does not create a second layer of tax deferral. The annuity may still be useful for contractual income, principal protection, or a death benefit, but "extra tax deferral" is not a valid reason by itself. Pretax money distributed from a qualified annuity is generally taxable as ordinary income. Required minimum-distribution rules also continue to apply according to the surrounding retirement arrangement.

A nonqualified annuity is purchased outside a retirement plan, usually with money that has already been taxed. The premium is called the investment in the contract or cost basis. Earnings grow tax-deferred while they remain inside, but tax deferral is not tax exemption. Before annuitization, withdrawals are generally treated as earnings coming out first and are taxable until the gain has been removed. The owner's after-tax principal then comes out without being taxed again. A taxable withdrawal before age fifty-nine and a half may also face a 10% additional federal tax unless an exception applies.

Annuitized payments from a nonqualified contract are usually divided into taxable and tax-free portions. The tax-free portion represents the gradual return of the owner's after-tax investment, while the remaining portion represents taxable gain. The ratio used to determine those parts depends on the contract, expected return, payout period, and applicable tax method. Once the owner's full cost has been recovered under the tax rules, later payments may become fully taxable. If death occurs before the cost is recovered, special rules may apply to the final return. [IRS Publication 939 explains how annuity payments are divided between a tax-free return of cost and taxable income.](#)

An annuity can be exchanged for another annuity without immediate taxation when the transaction satisfies Internal Revenue Code Section 1035. This is called a 1035 exchange. Tax deferral continues, and the cost basis transfers into the new contract. The absence of immediate tax does not prove the exchange is financially wise. Leaving the old contract may trigger a surrender charge, the new contract may begin another surrender period, and a salesperson may earn a new commission. An exchange should improve

benefits, cost, insurer strength, or suitability enough to justify everything being surrendered.

Sales compensation deserves attention because annuities can pay substantial commissions. The buyer may not receive a visible bill for that commission because the insurer can recover it through surrender charges, interest-rate spreads, caps, or ongoing expenses. A recommendation to replace a contract may benefit the seller even when the customer already owns a suitable annuity. The buyer should ask how the professional is paid, whether less expensive versions exist, and what specific weakness in the current arrangement requires replacement. A long list of new features has little value if the old guarantees are lost and the new costs absorb the improvement.

An annuity should be compared with the need it is meant to solve. Someone seeking lifetime income should examine the payment amount, survivor protection, inflation treatment, insurer strength, and access to emergency money. Someone seeking safe short-term interest may discover that a surrender period makes the annuity unsuitable. A person focused on leaving wealth to children may prefer liquid investments or a contract with carefully designed death benefits rather than a life-only annuity. A retiree already receiving enough guaranteed income from Social Security and pensions may need growth and flexibility more than another fixed payment. The product should follow the financial need instead of creating a need to justify the product.

Guaranteed income is especially useful for essential expenses. Housing, utilities, food, insurance, and basic medical costs do not disappear during a stock-market decline. Social Security, pensions, and annuity payments can create an income floor—a dependable amount intended to cover those continuing needs. Investments outside that floor can remain available for growth, emergencies, travel, gifts, and changing expenses. Converting every retirement dollar into guaranteed income can leave too little liquidity, while refusing any guaranteed income can expose the household to longevity and market risk. Balance matters more than loyalty to either side.

A strong annuity decision can be explained without sales language. The owner knows what was paid, when money can be accessed, how growth is calculated, what income is guaranteed, which actions can weaken the guarantee, what happens at death, and which company stands behind the promise. The owner also understands the fees that appear directly and the limitations that function as hidden costs. When those answers remain unclear, the contract is not yet understood well enough to purchase. Complexity should slow the decision rather than pressure it.

The purpose of an annuity is to transfer a chosen risk. A life annuity transfers the risk of outliving money, a fixed annuity transfers part of the investment risk, and a survivor option transfers part of the financial risk created by one spouse's death. The insurer accepts those risks in exchange for the premium, control of the assets, contract restrictions, and the opportunity to earn a profit. That exchange can be valuable without being magical. When the terms match the retiree's actual needs, accumulated money

stops behaving only like wealth on a statement and begins arriving with the steady rhythm of income meant to be lived on.