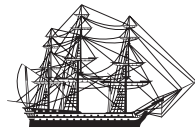


# Should You Consider an Income Annuity?

Plain Talk<sup>®</sup> Library



**Vanguard<sup>®</sup>**

If you're approaching retirement or you're already retired, you probably have many questions about the financial issues the years to come will bring. How will you pay for health care? Can you count on Social Security benefits? How should you manage your retirement plans? How can you protect against outliving your retirement savings? Learn about these and other retirement topics through our clear, candid Plain Talk investment guides. The series can help you become an informed consumer. Go to [www.vanguard.com/visit/plaintalk](http://www.vanguard.com/visit/plaintalk) or call **800-522-5555**.

**Most people enter retirement hoping that their retirement nest egg will last their lifetime.** But it doesn't always work out that way. If the financial markets swoon shortly after you retire, if your health care bills soar, if Social Security benefits decline, or if you live into your 90s, there's a chance you could run short of money.

To reduce the risk of outliving your assets, you could take a portion of your retirement savings and buy an income (immediate) annuity. It lets you convert a lump-sum payment into a regular stream of income payments that can last for your lifetime—or for as long as you or your spouse is living.\* Income annuities can help you turn a traditional or Roth IRA, a 401(k) plan, or part of your savings into a personal private pension.

If chosen wisely, an income annuity can help ensure that your basic living expenses are covered, reduce some of the uncertainty around your retirement income, and give you the flexibility to spend a little more from your portfolio than you might otherwise feel comfortable spending.

In this booklet, you'll learn how income annuities work, some of the payment options available to you, and how to choose an income annuity.

\*Subject to the claims-paying ability of the issuing company.

# How income annuities work

Income annuities work like life insurance, but in reverse. With life insurance, you make regular payments to an insurance company and, in return, the insurer pays your beneficiary a lump sum after your death.

With an income annuity, you pay an insurance company a lump sum and the insurer begins paying you a monthly income (or a quarterly, semiannual, or annual income) that can last as long as you—or you or someone else, such as your spouse—are living.

## How income annuities differ from deferred annuities

Deferred annuities like IRAs help you save for retirement during your working years by letting you defer taxes on your investment gains. Deferred annuities have provisions permitting you to elect to convert your accumulated value into an income stream. In practice, investors rarely choose this provision because it is not as favorable as immediate annuity payouts.

Income annuities, on the other hand, let you immediately convert a sum of money into an income stream, usually at or during retirement.

## Why you might need an income annuity

An income annuity can protect you from outliving your retirement savings. At age 65, American men have a 20% chance and women have a 32% chance of reaching age 90. Among couples, there's a 45% chance that one of the two will reach age 90, according to figures from the Society of Actuaries. By guaranteeing lifetime income, an income annuity literally insures you against the chance that you'll outlive your assets.

An income annuity also relieves you from having to guess how much income you'll have to spend in retirement. Since you don't know whether you'll live to age 75 or age 95, you won't know at age 65 how much of your assets you can afford to consistently withdraw each year. When you buy an income annuity, you strike a compromise. Your payout rate is based on the assumption that you'll reach the average life expectancy, and under the fixed payment option with a lifetime payout, you're guaranteed that payout for as long as you live.

And by eliminating some of the uncertainty surrounding your retirement income, you can gain flexibility in how much you spend from your portfolio.

# What income annuities cost

Annuities entail certain fees, so shop around for one with low fees and commission charges. If you buy an annuity through an insurance agent or other intermediary, you're likely to pay a commission or sales load. That's why it's advisable to buy directly from the issuer.

All annuities charge mortality and expense risk fees, which cover certain insurance company costs. In addition, if you choose variable income payments, you'll also pay investment management fees and possibly a fee if you perform too many transfers between investment portfolios in a year. You may also be charged a fee if you make partial withdrawals from an annuity. (Withdrawal options vary. You should consult the policy form. For variable annuities, consult the policy prospectus for complete details on withdrawals.)

## How much income you could receive

The income you receive from an annuity will depend on:

- The amount of your initial payment.
- Your gender.
- Your life expectancy (and your spouse's life expectancy, for a joint and survivor annuity) at the time you buy the annuity.
- The income payment options that you choose.
- The prevailing interest rates (if you buy a fixed-payment annuity).
- The future performance and expenses of the investment options selected (if you buy a variable-payment annuity).

For example, a 65-year-old man who purchased a fixed, lifetime annuity in 2006 with a one-time payment of \$100,000 could expect to receive about \$683 a month for life. A \$200,000 payment would produce double that amount, and so forth.\*

### > Web link

You can use Vanguard's online calculator at [www.vanguard.com/visit/incomecalc](http://www.vanguard.com/visit/incomecalc) to help determine how much income you might receive, based on your age, gender, payment options, expected purchase payment, and the date payments begin.

\*Guarantee of a fixed, lifetime payout is subject to the claims-paying ability of the issuing company.

### How income payments are taxed

Annuity payments are subject to ordinary income tax, but the tax treatment depends on whether you purchased your annuity with after-tax or pre-tax assets. One advantage of annuities is that they spread your tax liability more evenly throughout your retirement.

**After-tax assets.** If you buy your annuity with money that you've already paid taxes on—after-tax or “nonqualified” money—you pay income tax only on the part of each payment that represents a return of earnings. You owe no tax on the part that represents a return of principal.

When you buy your annuity, you'll learn how much of each payment will be taxable in the year you receive the payment. Generally, the payments you receive after you surpass your life expectancy are fully taxable as income.

**Pre-tax assets.** If you buy an annuity with money you haven't paid taxes on—the pre-tax money in a qualified retirement plan or traditional IRA, for example—you'll owe income tax on your entire annuity payment when you receive it (just as you would owe income tax on your withdrawals from your traditional or Roth IRA).\*

Note that the income you receive from an annuity purchased with pre-tax assets does not reduce the required minimum distributions you'll have to take from any remaining assets you have in tax-deferred retirement accounts.

Finally, some states charge a premium tax, up to 3.5% for annuities purchased with after-tax money and up to 1% on pre-tax money, on the assets you use to buy your annuity.

\*Depending on your age and how long you've held the Roth IRA, distributions may be exempt from federal income tax.

# Income annuity options

Buying an income annuity is like buying a new car: You need to choose the options that best fit your needs. These options let you tailor your annuity to your specific retirement goals. They can also affect the size of each periodic income payment.

## Fixed versus variable payments

When you buy an annuity, you have a choice of receiving fixed or variable income payments or, perhaps, a combination of both.

**Fixed payments.** If you choose a fixed income annuity, each payment is guaranteed to have the same value. (The payment guarantee is subject to the claims-paying ability of the issuing company.) You know exactly how much your income payment will be, no matter how the financial markets perform. Under some annuity contracts, you can also select a payout that adjusts for inflation by automatically increasing your fixed payment by a percentage each year or by tying payments to changes in the nonseasonally adjusted Consumer Price Index-U (CPI) published by the U.S. Bureau of Labor Statistics.

**Variable payments.** If you choose a variable income annuity, your payments will fluctuate with the performance of investment portfolios you select. Variable payments offer a chance for investment growth and potentially can keep pace with inflation. But they also involve the potential for loss. The value of variable payments, unlike the value of fixed payments, is not guaranteed.

**Combination payments.** Under many variable annuity contracts, you can opt for a combination of fixed and variable payments, so you get a predictable income plus exposure to the growth potential of the financial markets.

You may also be able to transfer assets from one option to another, providing you with the flexibility to adjust the allocation of your income distribution as you grow older, your risk profile changes, and your investment objectives become more conservative.

## Single life versus joint and survivor

You can buy an annuity for yourself or for two people, such as yourself and your spouse.

**Single life annuity.** If you purchase an annuity for yourself, you receive payments for as long as you live. Generally, payments under the single life option are larger than under the joint and survivor option.

**Joint and survivor annuity.** If you purchase an annuity for yourself and another person such as your spouse, the annuity contract guarantees income for you and the other person for as long as either of you is alive. Under this option, when you die, your survivor can receive either the same payment that you received or a reduced payment that reflects the survivor's lower cost of living. This survivor payout is elected when the annuity is purchased.

## Guaranteed payments

Regardless of whether you purchase a single life or joint and survivor annuity, you may elect to guarantee payments for a specified period.

**Single life with a guarantee.** If you choose a single life annuity, you can add a guarantee that you'll receive payments for no less than a specified period, such as 10 years or 20 years. If you die before the end of the guaranteed period, your remaining payments will go to your beneficiaries. Generally, payments under the single life option are larger than payments under single life with a guaranteed period option.\*

**Joint and survivor with a guarantee.** Full payments are made for as long as you or your survivor is living but not less than the guaranteed period. If both you and the survivor die before the period ends, your beneficiaries receive the remaining guaranteed payments.\*\*

## Guaranteed number of years only.

Under some annuity contracts, you can choose to receive payments that end with the guaranteed period, even if you live longer. If you die before this period ends, your beneficiaries receive the remaining payments.

**Single life with refund.** If you choose a single life annuity with fixed income payments, you can select either an installment or full cash refund option. The refund options are attractive if you want to ensure that at least your original investment is returned to you or your beneficiaries.

**Withdrawal of assets.** Some annuity contracts let you withdraw part of your annuity assets each year, but you must choose variable payments with a guaranteed period to qualify for that option. A fee may be charged for each withdrawal, and the withdrawal will generally reduce the size of your remaining variable income payments and the length of the guaranteed period.

## Types of income annuities

Type	Payment Description	Function
Fixed	A fixed amount, paid periodically as long as the owner lives	To earn a specific rate of return and for longevity insurance
Variable	The owner chooses the investments and receives formula-based income payments as long as he or she lives	For longevity insurance only

\*For a single payout option *without* a guaranteed period, the payments stop when the *annuitant* dies, regardless of the number of periodic payments made.

\*\*For a joint and survivor payout option *without* a guaranteed period, the payments stop when *both annuitants* die, regardless of the number of periodic payments made.

# Tips for choosing an income annuity

An income annuity may be appropriate if you:

- Want a guaranteed income stream you cannot outlive.\*
- Can afford to buy an annuity and still have other funds for investing, emergencies, or special purchases.
- Are not sufficiently covered by a traditional pension plan.
- Want money available to help pay expenses, such as everyday bills, the cost of long-term care, or life insurance premiums.
- Are concerned about your income keeping pace with inflation. Look for an income annuity with inflation-protection options.

When shopping for an income annuity, remember these rules of thumb:

- **Use only a portion of your savings.**  
It's generally best to use only part of your retirement nest egg to buy an annuity, because the purchase is usually irrevocable and you won't have direct access to the money if you need it in an emergency. Keep at least half of your retirement savings in more liquid, readily available investments.

- **Cover your important expenses.**  
Consider a fixed annuity whose payments will cover your basic living expenses, such as food, mortgage or rent payments, property taxes, utility bills, and insurance premiums. The knowledge that your basic needs will be met can offer considerable comfort in retirement.
- **Make sure you're in good health.**  
If you're in poor health, it may not make sense to buy an income annuity. The greater your expectation of living a long life, the more sense an income annuity makes. However, if you have a medical condition that might reduce your life expectancy, you may want to consider an income annuity that offers medical underwriting. This option may increase your income payments or reduce the premium amount needed to generate specific payments.

\*For a guaranteed income stream, consider purchasing a fixed annuity or investing in the fixed account of a variable annuity. The guarantee of an income stream is based on the claims-paying ability of the issuing company. Variable income annuities, which invest in the market through separate account funds, are subject to investment risk.

- **Avoid high annual fees.** Look for an annuity with low administrative fees, low mortality and risk expense fees, and low or no sales loads or commissions. Lower fees mean higher income payments because more of your money works for you and less goes to expenses.
- **Choose a financially strong issuer.** Buy your annuity from a company that will be able to make payments to you for the rest of your life. Look for an issuer that's highly rated for financial strength by rating agencies such as A.M. Best Company, Moody's Investors Service, and Standard & Poor's.
- **Choose the right payment period.** In general, the longer you intend to receive income payments, the smaller each payment will be, since the assets will be spread over a longer period. Payments for the single life option, for example, are typically larger than payments for the joint and survivor or single life with guaranteed period options. However, for lifetime income options without guaranteed periods, payments end upon the death of the annuitants.
- **Take note of prevailing interest rates.** If you're buying a fixed income annuity, bear in mind that the higher the interest rates are at the time you buy, the higher your income payments will be.
- **Consider buying over a period of time.** You may choose to purchase several income annuities over a period of time. Periodic purchases may allow you to offset interest rate risk.
- **Consult with a tax advisor.** You can use pre-tax or after-tax assets to purchase an income annuity. Before proceeding, you should consult a tax professional to determine which method is best for your situation.

Buying an income annuity is usually an irrevocable act, and it reduces the size of the estate that you can leave to your heirs. Consider these issues carefully before making a commitment.

Purchasing an income annuity through the Vanguard Lifetime Income Program® can help you greatly reduce the risk of outliving your retirement assets. Vanguard's income annuity has low costs, is backed by a highly rated issuing company, and offers flexible product features, such as inflation adjustments, medical underwriting, and a variety of income payment options. To learn more, go to [www.vanguard.com/visit/income](http://www.vanguard.com/visit/income) or call **800-522-5555**.



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The Vanguard Lifetime Income Program annuity is a single-premium immediate annuity issued by AIG Life Insurance Company (NAIC No. 66842), Form Nos. 14EGAN403 and 16GVIA1000, and, in New York State only, by American International Life Assurance Company of New York (NAIC No. 60607), Form Nos. 24EGAN403 and 26GVIA1000 and is distributed by American General Equity Services Corporation. Policies issued by AIG Life Insurance Company and American International Life Assurance Company of New York are solely the issuing company's individual, contractual, and financial responsibility. The Vanguard Group provides certain administrative and other services in connection with the Vanguard Lifetime Income Program. The Vanguard Group, AIG Life Insurance Company, and American International Life Assurance Company of New York do not provide tax advice. Investors are encouraged to consult a tax advisor for information on how annuity taxation applies to their individual situations.

The description of the Vanguard Lifetime Income Program annuity in this brochure is a summary only. It does not include all items, conditions, and exclusions of the annuity described. Please refer to the actual contract/certificate, and, for variable annuities, the policy and fund prospectuses, for complete details of the Vanguard Lifetime Income Program annuity.

As with any investment, there is risk.

**For more information about Vanguard annuity products, visit [www.vanguard.com](http://www.vanguard.com), or call 800-522-5555, to obtain fund and annuity contract prospectuses. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectuses; read and consider them carefully before investing.**