Understanding CD-type Annuities

CD-type annuities and CDs have been confusing investors over the years because of their similar names. Although similarities exist between the two types of investments, CD-type annuities and CDs are different investment vehicles which provide different benefits to the individual customer.

CD-type annuities are fixed annuities which are issued by insurance companies. CDs are issued by banks or brokers. What makes an annuity a “CD-type” annuity is that the term of the guaranteed rate matches the penalty period of the contract. For example, if a CD-type annuity is purchased at 3.5% for five years, the holder is guaranteed to receive 3.5% if the annuity is held for five years.

Many other fixed annuities have no maturity date and often only guaranteed the rate of return for the first year of the annuity contract. Usually, the interest rate drops after this initial guaranteed period and is then adjusted at normal intervals.

Typical rates for CD-type annuities range from 3 to 10% depending on the contract. A CD-type annuity can have a contract duration of 1 to 10 years.

CD-type annuities were originally developed so that people could clearly understand what the rate of return of their investment was. With normal fixed annuities, some investors who did not understand that the guaranteed period was for a limited period of time were becoming frustrated that they were not receiving the payments they were expecting and eventually paid the penalty fees to get out of their annuity. CD-type annuities were created to avoid this situation.

Although they share a similar name, CD-type annuities and CDs are different investment vehicles. Typically, a CD-type annuity will offer a higher rate of return than a certificate of deposit. Currently the advantage is about 1% for CD-type annuities over bank CDs.

CDs are not tax-deferred investments, unless they are held in a tax-deferred investment wrapper. CD-type annuities are tax-deferred investments. However, any purchaser needs to consider that if the CD-type annuity is cashed in before the age of 59 ½ then the IRS will impose a 10% penalty on the gain.

CDs are, however, insured by the FDIC for up to $100,000 if held in a non-retirement account. CD-type annuities are not insured by the FDIC. There is security, though, for CD-type annuities. They are covered by individual state reserves. These vary from state-to-state, but coverage usually ranges from $100,000 to $300,000.

Another advantage for CD-type annuities is that they can be rolled over without claiming the income for tax purposes. This is not possible with bank CDs.

Finally, partial withdrawals are allowed with CD-type annuities. Most contracts allow customers to withdrawal up to 10% of the annuity without paying a penalty. However, the IRS will charge a 10% penalty, as mentioned above, if the investor is younger than 59 ½.

CD-type annuities could be an advantage to an investor, especially if they are older than 59 ½. They offer a higher rate of return than CDs for the same guarantee period. Also, investors who are retired or near retirement age can avoid the 10% IRS tax penalty on CD-type annuities.