

Thinking About an Indexed Annuity? Take the Time to Understand them First

In June, the National Association of Securities Dealers (NASD) issued an investor alert on indexed annuities, calling them “A complex choice.” The Securities and Exchange Commission also sent letters of inquiry to the various providers questioning their marketing tactics.

Annuities can be complex in any form, but indexed annuities have come under particular fire lately because of aggressive marketing tactics and the risk that the insurance company issuing them might elect to change the various factors that affect the value of your investment. But before we get into that, let’s define what indexed annuities are.

Annuities are a contract signed between an investor and an insurance company in which the company promises to make periodic payments to you off your investment either immediately or over a specific period of time. If the payments begin right away, it’s known as an *immediate* annuity. If payments are not scheduled to start until some point in the future, it’s a *deferred* annuity. Further, annuities come in two flavors – *fixed* and *variable*. Fixed annuities guarantee both the rate of return and the amount of the payout. Variable annuities are invested in securities that fluctuate in value as the market fluctuates – there’s no guarantee of a specific return.

So what are indexed annuities? They’re a hybrid that has characteristics of both fixed and variable annuities. Their return is tied to a specific market index that may give you a slightly better return if the particular index appreciates. They also guarantee a minimum rate of return like fixed annuities, which the NASD estimates at 90 percent of the premium paid at a 3 percent annual interest rate.

Sounds like the best of both worlds, right? Not always, and this is where it makes sense to consult a financial adviser. You can indeed lose money in an equity-indexed annuity if your guarantee is less than the full amount of your purchase payments at the time you need to withdraw. In most indexed annuities, there’s a “break-even” requirement which requires you to stay invested usually at least 10 or 11 years. If you need to surrender your annuity early, you might pay a penalty of up to 10 percent of your contract’s worth.

It’s good to understand some of the features of an indexed annuity contract before you sign. The NASD provides the following examples:

- **Participation Rates.** A participation rate determines how much of the gain in the index will be credited to the annuity. For example, the insurance company may set the participation rate at 80 percent, which means the annuity would only be credited with 80 percent of the gain made by the index.
- **Spread/Margin/Asset Fee.** Some indexed annuities use a spread, margin or asset fee in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10 percent and the spread/margin/asset fee were 3.5 percent, then the gain in the annuity would be 6.5 percent. These terms and fees can change at will depending on the company selling them.

- Interest Rate Caps. Some indexed annuities may put a cap or upper limit on your return. This cap rate is generally stated as a percentage. This is the maximum rate of interest the annuity will earn. For example, if the index linked to the annuity gained 10 percent and the cap rate was 8 percent, then the gain in the annuity would only be 8 percent.

Also, it's critical to understand how dividends are handled in an equity-indexed annuity. If your return does not include the dividends paid on the underlying component securities in the index, you may be losing income.

What are other reasons to be careful in purchasing an equity-indexed annuity? Unlike other annuity investments and variable annuities in particular which are subject to government regulation, indexed annuities are not. That means that the individual selling them probably won't need to be licensed or subject to any regulation that brokers or securities dealers would be.

Another concern is the possibility that commissions and fees from the sale of these annuities might exceed those of the highest-load mutual funds, sometimes above 5 percent. Given all the costs and potential penalties involved in owning these instruments, it makes sense to determine if the guarantees provided by equity indexed annuities are worth the cost.

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Planning the Maximum: Retirement Contribution Limits in 2006 and 2007

For people who can afford to put away money in their retirement accounts, the decision of how much to put in often comes at the last minute, meaning at yearend or at the minute they're filing their taxes. But it's very important to keep track of contribution limits on a yearly basis so you can plan ahead to have the money available.

With the passage of the Pension Protection Act of 2006, the government will lift expiration provisions that would have limited contributions on many of these accounts over the long-term. Now, taxpayers will be able to save more at a time when most experts say the nation's retirement nest egg is way too low.

Here are the contribution limits currently allowed for tax year 2006 in hopes that investors might have a little more time to plan:

401(k) contributions: August's new pension law makes permanent higher contribution limits that were to have expired in 2011. That means the current annual contribution limit on 401(k)s, now at \$15,000 -- and adjusted for inflation next year to \$15,500 -- won't fall back to \$13,000 as originally planned. That could potentially lead to hundreds of thousands of dollars of difference in final savings.

Solo 401(k) contributions: Solo 401(k)s are 401(k)s designed for individual businesspeople. Employees may be allowed to contribute up to \$15,000 of their income and additional profit-sharing contributions as long as total contributions don't exceed \$44,000 for the 2006 plan year. That limit -- which applies to all defined contribution plans -- rises to \$45,000 in 2007.

403(b) contributions: Also up to a maximum of \$15,000 in 2006 and \$15,500 in 2007.

Traditional and Roth IRA contributions: In 2006, the maximum individual contribution will be the smaller of the following amounts: \$4,000 or your taxable employment compensation for the year. For 2006, if you're a taxpayer who is an active participant in a retirement plan at work, the ability to deduct your contributions to a traditional IRA will be phased out if your Modified Adjusted Gross Income (MAGI) is more than \$75,000 but less than \$85,000 for a married couple filing a joint return or a qualifying widow(er); more than \$50,000 but less than \$60,000 for a single individual or head of household, or less than \$10,000 for a married individual filing a separate return. Meanwhile, the Roth IRA contribution is phased out for MAGI from \$95,000 to \$110,000. For married couples filling jointly, the phase-out runs from \$150,000 to \$160,000.

Simplified Employee Pension (SEP) plans: The maximum deduction for contributions to a SEP remains unchanged at 25 percent of the compensation paid or accrued during the year to eligible employees participating in the plan. However, for 2006, the maximum combined deduction for a participant's elective deferrals and other SEP contributions has increased to \$44,000. On the contribution side, for 2006, the annual limit on the amount of employer contributions to a SEP has increased to the smaller of 25 percent of the eligible employee's compensation, or \$44,000 (subject to cost-of-living increases).

SIMPLE IRAs: Eligible employees in SIMPLE plans – which are funded by employer contribution and elective employee salary deferrals -- can elect to contribute up to 100 percent of compensation up to a maximum of \$10,000 for the 2006 plan year through salary reduction – that amount will rise to \$10,500 in 2007. Participants age 50 and older in 2006 may be able to make an additional annual \$2,500 catch-up elective deferral contribution to their SIMPLE-IRA.

Other catch-up options: For 2006, a 401(k) and 403(b) plan participant as well as traditional and Roth IRA participants who are age 50 or older at the end of the calendar year are allowed to make catch-up contributions of up to \$5,000. That amount will be adjusted for inflation beginning next year. The catch-up amount is the same for Solo 401(k) s and Thrift Savings Plans (TSPs) as well.

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Returning Military Need to Plan a Financial Re-entry to Everyday Life

It may be many months – if not years – before U.S. troops make a permanent exit from wartime service. However, it's never too early for military personnel and their families to start talking about the right financial steps to make when returning home.

One of the smartest moves a serviceman or woman can make if they've never done so is scheduling a meeting with a trained financial or tax adviser. This is best done before deployment, but it's never really too late to get advice. In the case of married military personnel, it might be wise for the spouse at home to locate a qualified financial planner near them to start the discussion. The Financial Planning Association can help connect you with experts by geographic area and specialty via PlannerSearch, www.PlannerSearch.org.

Here are some suggestions military personnel and their spouses should follow during deployment or at the end of their service:

Prevent identity theft: If a member of the military on active duty hasn't registered an "active duty alert" with the three major credit reporting companies (Transunion, Experian and Equifax), they should do so immediately. Such an alert – effective for one year but renewable -- automatically stops all credit offers from being mailed to their homes. A call to any one of the credit bureaus will automatically put an alert on an individual's file with all three agencies. For extra protection, get a trusted family member authorized to check your credit report annually and place or remove an alert in your stead.

Know your rights if problems occur: The Servicemembers Civil Relief Act of 2003 provides a variety of financial protections for active duty personnel. The act provides stays on civil litigation including bankruptcy and divorce and prevents wage attachments while military personnel are away. Coverage requires active duty confirmation from a commanding officer but expires 90 days after that status has been terminated. The law also makes it tougher – but not impossible – for landlords to evict military families for nonpayment of rent.

Note credit protections: The 2003 act also freezes credit card, mortgage and some student loan interest at 6 percent if military personnel were approved for the loans before they were called to active duty. On student loans, reservists and active duty members of the military assigned away from their permanent-duty stations may receive a deferment for up to three years on student-loan payments as well as a break on accruing interest on missed payments. Finally, deployed military away for at least six months can terminate a car, truck or other vehicle lease without penalty.

Understand tax issues: Activated and deployed military personnel receive special tax breaks at the federal and sometimes state level. Military income earned by soldiers in combat zones is tax-free and they don't have to file taxes until 180 days after their return. Activated military personnel also are entitled to an extension on the period of time allowed for a tax break on the profits from the sale of a home. They're also entitled to tax breaks on childcare assistance and certain travel. Nontaxable combat pay can also be considered for the Earned Income Credit.

Plan ahead for lump-sum earnings: For returning military receiving accumulated military pay or compensation from civilian employment, it's tempting to take the money and blow it. It makes sense to sit down with a financial and tax adviser before a dime gets spent.

Know injury benefits: The Veterans Administration's Traumatic Injury Group Life Insurance Program (TSGLI), launched late last year, has already distributed more than \$165 million in grants between \$25,000-\$100,000 for wounded troops. Servicemen and women need to register for the program for a monthly fee of \$1 for the extra coverage on top of what they pay for Servicemembers Group Life Insurance.

Don't forget retirement: Military service counts toward vesting for all civilian retirement plans -- even though employers may not always be required to give you your job back when you return. And thanks to the Heroes Earned Retirement Opportunities (HERO) Act enacted in May, military and their families can actually put more money into their traditional or Roth IRA accounts. The act allows tax-free combat pay to be considered as earned income for determining the contribution amount for traditional and Roth IRAs. Before, a military person who earned only combat pay wasn't allowed to contribute to either form of IRA.

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