

Immediate Annuities Offer a Source of Lifetime Income

The good news is we're living longer. But the prospect of a longer life expectancy means we risk outliving our retirement savings. If the thought of receiving a steady stream of income that lasts for the rest of your life appeals to you, a single premium immediate annuity (SPIA) might be worth considering.

How does it work?

Unlike a deferred annuity, which is designed for long-term savings, a SPIA begins to make payments to you immediately. In exchange for a lump sum of money you pay to an insurance company, you'll receive an income that can last for the rest of your life. The amount of income you receive is based on a number of factors, including your age at the time payments begin, your gender, whether payments will be made to only you or jointly to you and another person, and whether payments will be made for a fixed period of time or for the rest of your life or joint lives.

You have options

Most immediate annuities include a number of payment options. The more common payment options are:

- *Life only.* Payments continue during your lifetime, but stop at your death.
- *Period certain.* Payments are made for a fixed period of time (e.g., 5, 10, 15, 20 years). If you die prior to the end of the chosen period, your beneficiary will continue to receive payments for the remainder of the fixed period.
- *Life with a period certain.* Payments are made for the rest of your life or a minimum period of time. If you die prior to the end of the minimum payment period, the beneficiary you name in the annuity will receive the payments for the remainder of the period certain, but no longer. If you outlive the period certain, payments will end at your death.
- *Joint and survivor.* Payments are based on the lives of two people, typically you and your spouse. When either of you dies, payments continue to be made to the survivor. This option can also be combined with a period certain option, in which case payments will continue until both of you have died or for the minimum period of time you select, whichever is longer.

- *Installment refund/cash refund.* If you die prior to receiving at least the return of your investment in the immediate annuity, your beneficiary will receive an amount equal to the difference between what you invested and what you received. Your beneficiary will receive this amount in either a lump sum (cash refund) or periodic payments (installment refund).

The amount of each SPIA payment you get can be affected by the payment option you select. For example, a 60-year-old man who invests \$100,000 in an immediate annuity may receive annual payments of \$7,260 for the life only option, \$6,696 for life with a period certain of 20 years, or \$7,920 for a fixed period of 20 years. (This example is for illustration purposes only and does not reflect actual insurance products or performance, nor is it intended to promote a specific company or product.)

Are there taxes to pay?

Generally, you pay income taxes on that portion of each payment that represents earnings or interest credited to the immediate annuity. The remaining portion of each payment is considered a return of your investment and is tax free.

Other factors to consider

While a SPIA can offer a measure of relief from retirement income concerns, as with most investments, there are other factors to consider. Generally, once you invest in a SPIA, your payments are "locked in" with little flexibility, although there may be some exceptions. Normally, you don't have access to the principal unless the annuity provides for it, so be sure the payment option you select will meet your income needs. Also, consider whether there are other investment choices available that may better suit your retirement income goals. Your financial professional may be able to present different options, including a SPIA, for you to consider when deciding how to best meet your retirement income needs.

Exceptions to the Early Distribution Penalty

Generally, taxable amounts you withdraw from an IRA, 403(b), or qualified retirement plan before age 59½ are subject to a federal 10% penalty tax (and possibly a state penalty tax, too) in addition to any federal (and possibly state) income tax due. SIMPLE



IRAs are subject to a 25% penalty for premature distributions made during the first two years of participation. Fortunately, Section 72(t) of the Internal Revenue Code lists several exceptions to this premature distribution penalty tax.

Exceptions applicable to all plans

A qualified transfer or rollover from one retirement plan to another generally isn't subject to the penalty tax. Also, distributions made to your beneficiary or your estate after your death aren't subject to the early withdrawal penalty. Other exceptions include:

- Distributions not exceeding the amount of your tax-deductible unreimbursed medical expenses.
- Distributions made because of a qualifying disability.
- Amounts levied by the IRS directly from your qualified retirement plan. This exception doesn't apply if you withdraw funds from a plan to pay the IRS.
- Qualified reservist distributions pursuant to the Pension Protection Act of 2006.

Exceptions applicable only to IRAs

The 10% penalty doesn't apply if the distribution is made for you, your spouse, or your child or grandchild to pay qualified postsecondary education expenses, such as tuition, and room and board. If you're a first-time homebuyer, you can take pre-59½ IRA withdrawals if they're used to pay the costs of acquiring, constructing, or reconstructing your principal residence up to a \$10,000 lifetime limit. You also can take penalty-free IRA distributions up to the cost of health insurance premiums you pay during a qualifying period of unemployment.

Exceptions for non-IRA retirement plans

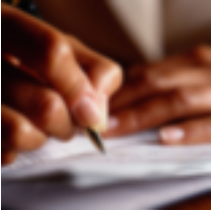
Distributions made pursuant to a qualified domestic relations order (QDRO) are not subject to the penalty. Also, you can take penalty-free withdrawals from a qualified plan after separating from service with the employer maintaining the plan if your employment ends during or after the year you reach age 55. You may also be able to take qualifying distributions of dividends from your employer's employee stock option plan without penalty.

Substantially equal payments exception

An important exception that applies to all IRA and qualified retirement plans is the substantially equal periodic payments exception. To comply with this exception, you must withdraw funds from your retirement plan at least annually based on an IRS-approved distribution method. For qualified plans (but not IRAs), you also must have separated from service with the employer maintaining the plan.

There are three IRS-approved methods for calculating payments, but regardless of the method you choose, you generally can't change or alter the payments for five years or until you reach age 59½, whichever occurs later (although the IRS has held that owners can make a limited one-time switch between certain methods without incurring the penalty tax). Otherwise, if you modify the payments (e.g., by taking amounts smaller or larger than required distributions or none at all), you will be subject to the 10% premature distribution tax on the taxable portion of all pre-59½ distributions (unless another exception applies).

Ask the Experts



What is an expense ratio?

Every mutual fund must disclose certain costs associated with running the fund. Those costs, which are expressed as a percentage of the fund's assets, represent a fund's expense ratio, which can be found in its prospectus. For example, a fund that has \$100 million in assets and annual expenses of \$1 million would report a 1% expense ratio (1% of \$100 million equals \$1 million).

An expense ratio includes the following:

Management fees: Fees paid to the fund's investment manager or advisor, which manages the fund and makes investment decisions. These often represent the single largest portion of a typical fund's expense ratio.

Marketing costs: Also known as 12b-1 fees, named after the legal provision that permits them. These were originally designed to let funds recoup costs associated with distribution and advertising, on the theory that attracting new investors and additional assets would help make a fund more cost-effective for each investor.

In recent years, there has been discussion of whether 12b-1 fees should be eliminated--especially for funds that are closed to new investors and therefore should have little need to market themselves--but they are still very common.

Administrative fees: Includes the cost of record keeping, custodianship, taxes, and legal, accounting, and auditing services.

A fund's expense ratio can help you gauge how efficiently it operates. You do not need to deduct a fund's expense ratio from the returns quoted in its prospectus; the figures that measure average annual and cumulative return have already taken them into account.

Before investing in a mutual fund, carefully consider its investment objectives and risks as well as its charges and expenses. This information is available in the prospectus, which can be obtained from the fund. Read it carefully before investing; a fund's expense ratio can affect your long-term net returns.

What are trading expenses and why do they matter?

Trading expenses represent the cost of buying or selling securities, and can have a substantial impact on your net return over time.

Brokerage commissions are the most obvious example of trading expenses, but there are others. For example, the bid/ask spread is the difference between the price sellers are asking for a security and the price buyers are willing to pay for it. Still another example of trading expenses is what's known as market-impact effect costs, which occur when an institutional investor's purchases or sales of large quantities of a given security affect that security's price. If you use leverage--for example, if you buy on margin--you will likely pay interest, which also should be included in your estimate of trading costs.

For individual securities, it's relatively easy to know what your trading costs are. However, with a mutual fund, understanding the impact of trading expenses can be more challenging. Funds also incur brokerage commissions and bid/ask spreads on their trades, but those costs aren't included in a fund's expense ratio.

However, funds are required to report the per-share cost of their annual commissions; this can be found in a fund's annual report or Statement of Additional Information. Many investors use a fund's turnover ratio to help gauge the impact of its trading expenses. The turnover ratio indicates the value of a fund's trades as a percentage of its net asset value. Trading expenses for a fund with a high turnover ratio would typically be higher than for one that trades infrequently and therefore incurs fewer brokerage commissions.

Though not part of a fund's internal trading expenses, there are other potential trading costs of which you should be aware. A fund may charge a redemption fee if you sell your shares before a designated length of time. It also may impose a sales charge, either when you buy a fund (a front-end load) or sell it (a back-end load). Not all funds have a redemption fee or sales charge, but they should be considered when estimating your total trading costs.

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Dave Williams is originally from Philadelphia, PA. He has been a "transplanted" Hoosier for the past 30 years. Dave strives to educate his clients on how to invest profitably and avoid loss by providing conservative options. He is dedicated to properly helping his clients reap the rewards of a well planned retirement. In addition, Dave is a well established speaker in Indiana and is committed to educating the community with his workshops on topics relating to conservative alternatives. Dave is a graduate of Indiana University with a BS in Finance. He is also a member of the National Ethics Bureau. He resides in Indianapolis with his wife of 27 years, 3 mini-Daschunds, and is enjoying his new granddaughter, Elly.



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