Investment GUIDE with Eric Tyson

Questions & Answers for Financial Success

Fixed Annuities

Q Our auto and home insurance company recently sent us a solicitation for a fixed annuity paying 4.75 percent. The letter stated that "the stock market's very jumpy, interest on CDs is taxable and even money market funds are paying low interest rates." This fixed annuity promises safety, higher interest rates and tax-deferral for greater long-term returns. It sounds enticing – what's the catch?

A Your instincts are good to question an ad. The quoted interest rate is typically only guaranteed for a set period of time, such as one year, as is the case for the annuity you were pitched. After that, the interest rate is set at the discretion of the annuity company. While policies may have a minimum interest rate that sets a floor, that rate is generally well below the initial interest rate.

As for the tax deferral, that part is true. However, the ad neglects to mention the rest of the tax story. When you withdraw money from your annuity, all of the investment earnings are taxed at the relatively high ordinary income tax rates. By contrast, if you invested your money in a portfolio of stocks and bonds (which is what the insurer does with your annuity money), investments held for more than one year and stock dividends qualify for the far lower long-term capital gains and stock dividend tax rate.

Fixed annuities are quite lucrative – for the insurer behind the annuity. The insurer typically earns about seven to eight percent per year on average on their investment portfolio of bonds and stocks, and they pay you far less, reaping the difference. If you instead put your money into a balanced mutual fund of bonds and stocks, rather than having several percent of your money siphoned off annually, you could pay a management fee far less than one percent.

IRA Withdrawal

Q I am a few years from needing to withdraw money from my Individual Retirement Account, which is invested in various mutual funds. Given the stock market slump of recent months, should I sell now to prevent further losses?

A Assuming your IRA is properly diversified (i.e., not all in stocks, with a healthy helping of bonds), no, I don't think you should sell. Stocks should bounce back, and they have already started to do so.

Even though mandatory IRA withdrawals begin the year following the one in which the account holder reaches age $70\,^1/_2$, remember that only a small portion of an account balance must be withdrawn based upon IRS tables of life expectancy.

As there are different ways to determine beneficiaries and life expectancy, be sure to get a grounding in these areas before you need to make these important elections. Consult with a tax adviser and/or pick up a tax guidebook such as the latest edition of *Taxes for Dummies* (Wiley) for more information.

One final note: If you don't need to spend the money as it's withdrawn from your IRA, you could simply reinvest it into the funds you're selling to make the withdrawal.

Totten Trust

Q I have several bank accounts (because I exceeded the FDIC limit of $100,000) that I would like to leave to my son. I have heard that if I set up a Totten trust for my bank accounts, I can do so without costly wills and other legal documents, and keep my assets from probate. Is this true? What exactly is a Totten trust?

A Totten trusts can be created by bank account holders so that the bank account is still in the account holder's name, but names a beneficiary (in this case, your son) to whom the account will pass upon the account holder's death. It is true that this type of trust will keep the underlying accounts out of probate.

However, a Totten trust should not be viewed as a substitute for a will or other important estate-planning documents, such as a living trust. I'm sure that you have other assets, including personal property, besides your bank accounts, and a will delineates to whom you would like all of your holdings to go. Furthermore, a will specifies who will handle the administration of your estate.

Also, if you hold other non-retirement assets, which could be subject to probate besides your bank accounts, a living trust may be of benefit to you to keep those other assets out of probate.

Last but not least, you should question if it makes sense for you to keep so much of your wealth in low-interest bank accounts, especially if you plan to pass it to your son. You could invest more aggressively and/or begin a program of giving to your son. **N**

Eric Tyson is a best-selling author (Personal Finance for Dummies, Investing for Dummies, Mutual Funds for Dummies, Home Buying for Dummies)*, and his syndicated newspaper column, "Investor's Guide," is read by more than four million people nationwide. A management consultant to Fortune 500 financial service firms, he also founded a counseling firm providing financial advice to non-wealthy investors, and has been a featured speaker at a White House conference on retirement planning. Educated at Yale and Stanford, and quoted in hundreds of local and national publications and media outlets, he teaches that one must live within one's means as a prerequisite to building wealth.*