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The Difference Between a CD & a Fixed Annuity (By eHow Contributing Writer)

Certificate of Deposits (CDs) are issued by banks, and annuities are issued by insurance companies. Understanding some differences may help you decide which one is best for you.

What is a CD?

- CDs are issued by banks and offer investors a safe place to invest their money. CDs grow based on a stated interest rate by the issuing bank over a predetermined time frame, such as three months, six months or one year. CDs are not based on the stock market or any other volatile index. Once the CD reaches the end of its period, the bank will automatically roll the CD over into a new period at a rate the bank is paying currently. The interest rate is only guaranteed for the duration of the CD period and can and will change. The periods can also range up to five years depending on the bank issuing the CD. Typically, the longer the duration of the CD period, the higher the interest rate the bank will pay.

What is a Fixed Annuity?

- Fixed annuities earn interest much like a CD does, but usually only on an annual basis on the policy anniversary. Fixed annuities are issued by insurance companies, and they earn an interest rate stated each year by the insurance company. Like a CD, fixed annuities are safe investments and not based on the stock market or any other volatile index. Insurance companies also offer multiyear guarantees on an interest rate. For example, an insurance company may offer a guaranteed 5 percent interest rate for the first five years. When this time period is up, the insurance company then has a right to drop the rate down to a minimum guarantee allowed by the state it is operating in, such as 1 percent or 1.5 percent.

What are the Differences?

- There are many similarities when it comes to CDs and fixed annuities, but there are also differences. One of the main differences is the fact that fixed annuities offer tax-deferred growth of your money. With a CD, the bank will send the owner a 1099 form at the end of the year listing the amount of interest earned. This amount must be included on the owner's tax return and is subject to ordinary income tax. A fixed annuity, however, grows tax deferred, meaning there is no tax reporting of interest year by year. The tax is paid by the owner when he or she withdraws from the annuity, so the owner is capitalizing on triple compounding--interest on principal, interest on interest and interest on money that would've been paid in taxes. Fixed annuities also may carry a declining surrender charge schedule and have some different liquidity features than CDs. Typically, the insurance company will allow the owner to withdraw up to 10 percent of the value of the annuity

each year without having to pay any surrender charges. If the owner withdraws more than 10 percent, the insurance company may impose a surrender charge. This amount decreases each year until it reaches zero. Annuities also are considered retirement accounts and are subject to a 10 percent penalty if the owner withdraws any amount prior to the age of 59 1/2.

What are the Real Guarantees?

- CDs and fixed annuities both have guarantees backed up by the government. CDs fall under Federal Deposit Insurance Corporation (FDIC) insurance. In the past, the amount that was insured in banks was \$100,000, but that recently was changed by the federal government to \$250,000 until December 31, 2013, in light of the recent economic turmoil experienced in this country. Annuities are not backed up by the FDIC but instead by each state's guarantee funds that help pay claims for financially impaired insurance companies. This amount varies by state.

Which One is Best for Me?

- Choosing between CDs and fixed annuities depends on a number of factors: your age, your tax situation and your investment objectives. Consult a financial professional who can help you assess your situation and make recommendations based on your objectives, risk tolerance and tax status. Read all prospectuses and make sure you completely understand what financial product you are buying before investing any money. Following these guidelines should help you eliminate any surprises or financial mistakes.

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