Course Objective

This course was created to educate Life Insurance Agents, Estate Planners, CPA/accountants, EAs, and Attorneys about the very interesting but confusing topic of annuities. While many non-insurance or securities licensed professionals do not choose to take the time to educate themselves about annuities, after reading this material they will understand why they need to know about annuities in order to give complete planning advice to clients.

This material will explain the different types of annuities, each of their many moving parts and how to understand which annuity is best suited for certain clients. Plus, this material will explain why indexed equity annuities should be used for clients nearing retirement to protect their wealth while still giving the clients good upside growth potential with the investment.

Overall, this course covers basic, intermediate and advanced course material that every CPA/accountant, attorney and financial planner advising high net worth clients should know.

Tax Deferred Annuities

Introduction

In the past three decades tax deferred annuities have emerged as a commonly used planning tool by financial advisors and estate planning attorneys as well as CPAs/accountants. As the financial services industry has undergone dramatic change, depository financial institutions, brokerage firms and insurance companies have changed their product menus to appeal to a broader spectrum of the investing public. In particular, insurance companies have diversified their operations away from the management of mortality and morbidity risk to include investment risk. This has been prompted partially by increased competition from banks and brokerage firms but also because the general population's demand for traditional life insurance products has been replaced with a demand for "transactional" investments. As the country's population has increased in age, due to medical advancements that have increased longevity, and the demographic bubble known as the "baby boomers", there has been an increased focus on retirement planning.

Enabling legislation at both the federal and state level has been put in place to foster the erosion of the barriers between the traditional sectors of financial services. Beginning in the early 1980's depository financial institutions and brokerage firms started aggressively offering insurance products, especially transactional ones like annuities, as the financial services industry started its march toward "one stop" financial shopping. The concentration of both banking and brokerage has accelerated this trend as the U.S. financial services sector

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has adopted the European model of integrated financial services. Currently, the financial services sector is still in transition toward horizontal integration and it appears that this trend will continue into the foreseeable future; however, the speed will wax and wane in reaction to political and economic realities.

It is clear at this juncture that the toehold that insurance companies have in traditional banking is not going to be lost, short of a legal ban, and the same is true for the horizontal integration of traditional banking companies and brokerage firms. The cross pollination between the sectors of the financial services industry has also prompted the sales forces of each to add to their offering menus the products of the others. Accordingly, it is now routine for "insurance agents" to offer registered securities (stocks, bonds, mutual funds, etc.) and even banking products and services (CDs, money management, mortgage loans). Likewise, stockbrokers and bankers are offering insurance products.

This melding of institutions and their sales forces is likely to continue without interruption. Additionally, in recent years there has been a growing interest in financial services by CPAs, enrolled agents, general accountants and attorneys. After all, tax and estate planning are an integral part of financial planning, so adding investment advice and financial products is a natural corollary for these professions.

Marching in lock-step with the increase in the number of participants offering financial services, has been a number of other developments: more regulatory oversight by governmental agencies and political bodies; jurisdictional disputes among the regulatory agencies over control of the participants and their activities; increased educational emphasis that has resulted in more, and better, professional designations for participants; mergers and consolidations of trade associations and groups; emergence of consumer groups as countervailing powers to challenge the strength of the consolidating financial services institutions.

This confluence of heightened demand and horizontal expansion of financial services across a broader spectrum of institutions has brought financial services front and center. Given the expectation of continued melding in the financial services industry and the looming financial disruptions when the baby boomers move full force into retirement, we can expect conservative investments that offer safety, tax benefits and market rates of return to take on added importance. Annuities offer these features and the consensus opinion of financial services professional is that they have a bright future as the focus on retirement lifestyles sharpens.

One of the problems facing the general public is the fact that most advisors do not have a full understanding of all the annuities available and how to use them to best help their clients. Whether you are a licensed insurance agent, securities professional or a non-licensed CPA/accountant or attorney, having a

working knowledge of the different types of annuities and the many varieties of each type available is a must. Advisors are constantly looking for ways to provide improved service and products to better help existing clients and attract new clients. Learning about annuities will help them meet these goals.

What is an Annuity?

An annuity is a contract between a buyer, or contract owner (typically an individual), and the issuer (typically an insurance company) whereby the contract owner agrees to pay the issuer an initial premium or payment in a lump sum, or payments over a period of time, during which the issuer guarantees the owner a stated minimum rate of return or the opportunity to participate in the growth of an underlying group of assets in which the annuity premiums are invested. As with all contracts there, are numerous terms and conditions that influence the features and benefits that accrue to the owner.

Insurance companies are "rated" by the various rating agencies for claims paying ability as well as general solvency. The best known of the rating agencies of insurance companies is A.M. Best and Company, which has been rating insurance companies since 1899. Their ratings for claims paying ability range from a high A++ to a low of F. Generally, a company rated B++ to A++ is thought of as "financial sound" with little if any risk to the policyholders. Once the rating drops below this range there is need to investigate further the ratings of the other agencies (Standard and Poor's [S&P], Moody's, and Fitch). There are other rating agencies of second order magnitude, but the above-named are ones that financial analysts consider.

Once an insurance company's rating is downgraded, the rating agencies generally will err on the side of caution before restoring a higher rating. This practice means that a company may *de facto* deserve a higher rating but it will not be awarded until a certain probationary period has passed. S&P and Moody's rate insurance company based on financial solvency as they would a non-insurance company and have a tendency to be more stringent in their ratings. Again, any rating of B++ or above is "investment grade" and generally out of harms way from financial trouble.

In years past there have been notable exceptions of highly rated insurance companies encountering financial difficulties, and these anomalies have pushed the rating agencies toward even more conservative ratings – much to the chagrin of companies struggling to recover from a downgrade. As a practical matter, failed insurance companies, especially the smaller ones, are forced into mergers and consolidations by the regulatory authorities and financial default does not occur. Nonetheless, planners and advisors should pay attention to ratings and make sure their clients are aware of the rating at the time an annuity is purchased as well as any changes that might occur post-purchase.

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The annuity contract is generally called a "Policy" because it is issued by an insurance company, and the owner is generally referred to as the "Policyholder". This terminology is in general use even though the annuity is technically not an "insurance policy" in the traditional sense; however, it may have some of the attributes of a life insurance policy, e.g., a death benefit. There are three general classifications of annuities: fixed, variable and immediate. These will all be discussed.

There are generally three parties to an annuity: owner, annuitant, and beneficiary. The **owner** is the individual, or individuals, who own the cash benefits of the annuity. The owner is typically the only party who can redeem the annuity for its cash value, change beneficiaries, and make other changes allowed by the annuity contract. An annuity owner can be an individual, a trust, or a business entity.

The **annuitant** is generally the individual on whose life the death benefit is contingent. The annuitant may be, and oftentimes is, the same as the owner, but this is not required. Generally, the death of the annuitant triggers the payment of the death benefit of the annuity; however, there are annuities that provide for the payment of the death benefit upon the death of the owner only, or the death of the annuitant only or at the death of either. Accordingly, care should be taken in determining the owner and annuitant to avoid the owner losing control of the annuity proceeds upon the death of the annuitant. For example, if the annuity pays the death benefit upon the death of the annuitant, it may be prudent to list the owner as the primary beneficiary and name others as secondary beneficiaries. This structure insures that the owner will retain control of the cash value of the annuity in the event the annuitant dies and the death benefit is paid.

The **beneficiary** is the individual or entity that is named to receive the death benefit of the annuity. Beneficiaries may be multiple and the owner can generally add and delete a beneficiary by notifying the issuing insurance company of the change. If an annuity has a named beneficiary when the death benefit is triggered, the annuity will generally avoid the probate process. Since the issuer must pay the cash proceeds of the annuity upon the death of the owner, or annuitant, age limits on both the owner and/or annuitant are imposed. Most annuities will not automatically allow a change of the annuitant because of the age-driven feature of the death benefit.

The period of time that the annuity is growing in value, which may also be increased by additional premium payments into the annuity, is referred to as the **accumulation period**. The accumulation period may be indefinite, but in most cases there is a set limit, generally determined by the age of the owner or annuitant, or a set period following the initial premium payment. Once the end of the accumulation period is reached, the pay out period, or phase, of the annuity begins. During the pay out period the owner will receive a series of payments, or a lump sum, that is selected from a menu of options. Once the schedule of

payments is completed, or upon death of the last named recipient if a "life only" payout is selected, the annuity ends and the contract, or policy, is terminated. A single premium immediate annuity ("SPIA", pronounced spee-uh) does not have an accumulation period and will be discussed later.

What are the common characteristics of all annuities?

"Commercial" Annuities are issued by insurance companies and at this date are not permitted to be issued by other financial services providers; however, these non-insurance company participants may offer the annuities of insurance companies to the general public through licensed insurance agents (or advisors with a security license and an insurance license when selling a "variable" annuity) in their employ or under contract.

Insurance companies, banks and brokerage firms may own each other; accordingly, a bank or brokerage firm may "indirectly" issue an annuity through a subsidiary which is an insurance company. Only insurance companies can "appoint" insurance licensed individuals and entities to offer annuities to the general public.

Insurance companies are regulated by the various State Insurance Departments that oversee and approve every annuity offered in their state.

An annuity may be an "individual annuity" meaning that it was approved for sale to individuals, or it may be classified as a "group annuity" to be offered to a group of individuals acting as a single individual, e.g., a group pension plan. By and large, the annuity most likely to be encountered by a financial planner or advisor will be the "individual annuity".

You will sometimes see reference to "private annuities". A private annuity is an unsecured promise of one person (the obligor) to make fixed payments to another person (the annuitant) for life or a period certain in return for the transfer of property (generally) from the annuitant to the obligor. Private annuities are routinely "funded" using commercial annuities issued by insurance companies. **The use of private annuities is considered a specialized area of financial planning and is beyond the scope of this Chapter.**

Variable annuities

As stated previously, insurance companies, and in turn, annuities are regulated by the various State Insurance Departments. In recent years there has been substantial debate about the efficacy of retaining this regulatory structure because some annuities, e.g., index linked fixed annuities, now have features that many contend mirror those of variable annuities. Variable annuities are

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classified as “securities” and are regulated by the Financial Industry Regulatory Authority (**FINRA**) (formerly the Securities and Exchange Commission of the Federal Government (“SEC”)) and the salespersons offering securities must be licensed by the NASD (formerly known as the National Association of Securities Dealers).

Both the NASD and FINRA contend that the performance, and thus earning potential, of index linked fixed annuities is dependent upon the movement of the stock and bond markets and, therefore, should come under their jurisdiction. State Insurance Commissioners, on the other hand, content that these annuities guarantee a minimum fixed positive rate of return if held for the contractual term and, therefore, are not securities but insurance contracts that come under their jurisdiction. Furthermore, they argue that the Ferguson-McCarran Act of 1945 passed by the U.S. Congress placed the regulation of insurance with the various states and not the federal government. It appears likely that the Insurance Commissions will prevail in this argument but the controversy will continue.

Meanwhile, the NASD has extended their regulatory guidelines, at least as interpreted by most member broker-dealer firms, for variable annuities to include the index linked fixed annuities. The logical sequel to this controversy is a litigation initiated by one or more of the warring parties that will allow the courts to resolve the issues. At this time, the sale of index linked fixed annuities is permitted if the salesperson possesses only a valid insurance license issued by the state in which the sale occurs and is regulated by the various insurance departments of the states, not the NASD or FINRA. Discussions continue about “federalizing” insurance regulation, but at this time this does not appear plausible.

Tax-deferral

All tax qualified annuities, regardless of classification, offer income tax deferral of earnings until the earning are withdrawn. This tax deferral feature of annuities has given rise to the saying that annuities enjoy “triple compounding”: interest on the principal, interest on the interest left in the annuity, and interest on the money that ordinarily would have been withdrawn to pay taxes. The only exception to this tax deferral exception is an annuity that is owned by an entity that is not an individual or in trust for an individual. Such entities are allowed to own annuities; however, there is no tax deferral generally available and an individual must be named as the annuitant.

Withdrawals

Withdrawals from an annuity are currently subject to taxation on a last-in, first-out basis unless they are annuitized over a finite period of time or for life. Parenthetically, some older annuities may still qualify for the first-in, first-out tax treatment. The tax deferral feature of an annuity is rooted in the original purpose

of the annuity, viz., to pay an income to the owner in retirement. While annuities are now owned for reasons other than retirement or to fund a stream of future income payments, the tax-deferral feature of the annuity has endured as insurance companies have lobbied effectively to retain this benefit. From time to time there are rumblings in Congress to do away with the tax deferred status of annuities but to date there have been no serious challenges.

Asset protection

This "retirement purpose" of an annuity has also immunized them from creditors in many states. As the use of annuities has changed so have the attitudes of the various law-making bodies of the states and at this time there is great variability for annuities among the various states regarding creditors. Accordingly, the reader is advised to confirm the "creditor exempt" status of annuities in the states in which they are used. Obviously, even in states that exempt annuities from creditor claims there are always extenuating circumstances that could negate their exempt status. Accordingly, be careful when referring to annuities as "creditor proof".

1035 exchanges

One annuity may be exchanged for another annuity in accordance with the Internal Revenue Code Section 1035(e). Such 1035 exchanges do not trigger a taxable event and may be affected at any time regardless of the age of the owner or annuitant. Furthermore, the cash value of a life insurance policy may also be exchanged for an annuity without tax consequences, but the reverse is not permitted without triggering a taxable event. It should be noted, however, that many insurance companies will not honor "partial transfers" or the transfer of one annuity into multiple annuities. The reason generally cited is that their legacy computer system does not have this capability as partial, or multiple, transfers have only recently been permitted and when the annuity was placed on their "system" no provisions were made for such activity.

A more likely explanation is that issuers create impediments to transfers because they do not want to lose the funds. Nonetheless, the Revenue Service has ruled that partial exchanges may occur and that one annuity may be exchanged for two or more like annuities without taxable consequences. The exchanges in accordance with Section 1035 must occur exactly as permitted to avoid taxation; therefore, the reader is advised to review this section of the Code prior to exchanging annuities or exchanging the cash value of a life insurance policy for an annuity.

Investment protection

All annuities are also protected by the various State Guaranty Funds. These are reserve funds maintained by states to safeguard the cash value of

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policies, up to a certain limit, in the event an issuing insurance company is unable to meet it obligations under the contracts. A state's guaranty fund is maintained by assessing all legal reserve insurance companies selling life insurance and annuity contracts in the state, and by having back-up access to the state's general funds in certain situations. Coverage levels vary from state to state, but all funds offer at least $300,000 of death benefit protection, and $100,000 of coverage for the cash value of annuity contracts and other types of insurance. State Insurance Commissioners have the authority to liquidate, merge, consolidate or rehabilitate failed insurance companies, and the "remedy" they choose is conditioned upon minimizing the impact upon the guaranty fund of their state. Keep in mind, policies of a failed insurance company are not immediately and absolutely paid upon failure. The usual procedure is a long drawn out affair that leaves the policyholder with only limited, or emergency, access to their funds until the "optimum" resolution is crafted.

Payment options

All annuities have options for payment during the payout phase. These range from a single lump sum payment to a periodic payment over the remaining life, or joint lives, of the owner or owners. In between, the owner may choose a period certain, usually no shorter than two years and no longer than thirty years (with five and twenty being the most common range). Also, the owner may select a payment for a period certain with a life option, meaning that if he/she dies prior to the period certain (say 10 years) the payments would continue to the named beneficiary until the end of the stated period. Joint owners may select a life option that states a given payment until the first dies and thereafter the payment continued in the same amount or reduced (one-half, one-third, etc.) until the second party dies.

Some annuities state that if the life option is chosen and the owner dies prior to all the paid-in premiums being paid out, the beneficiary will receive the difference between what was paid in and payment received by the owner prior to death. The payments during the pay out phase can generally be directed to one or more parties. Many annuity issuers will work with policyholders to craft a custom pay out structure for the owner. In recent years there has been an increased emphasis on pay out options, including ones that provide for an accelerated lump sum based on the present value of the expected future payments; thus, new pay out options can be expected in response to a higher incidence of annuitization.

Death benefits

Death benefits are also a common feature of all annuities. The contract states the exact provision, which varies from full market value to a stated percentage of the market value at death. Some annuities impose the surrender penalties, if still in force, at death whereas others do not. The death benefit can

vary between contracts of the same insurance company; thus, the reader is advised to review each annuity's death benefit provision to ascertain the exact terms. Also, the selling advisor is sometimes subjected to a partial or full commission charge back if death occurs during a certain period following issue of the policy, generally one to three years. This, too, varies by products and carriers, and warrant close inspection prior to offering an annuity. Death benefits paid to beneficiaries of annuity contracts will be included in taxable income to the extent that they exceed the basis of the decedent in the annuity contract at the date of death. If the beneficiary elects, within one year of death, to receive a life income or installment option, then he or she will be taxed under the annuity rules.

Surrender charges

Surrender charges for early surrender are almost universal for annuities. These are sometimes called contingent deferred sales charges ("CDSC") and are imposed for a stated period of time, generally from one to twenty years depending on the annuity. Surrender charges are deducted from the cash amounts of the policy prior to being paid to the policyholder. Surrender charges are clearly stated in the contract and characteristically decline each year after the first and disappear at the end of the stated period. For example, a "typical" annuity might have ten years of surrender charges beginning at 10% in year 1 and stepping down 1% per year and completely disappearing at the end of 10th years. Some annuities provide for a surrender-free window at the end of the initial surrender charge schedule but, if the annuity funds are not withdrawn or exchanged, a surrender period starts over again.

If an annuity allows additional premiums after the initial premium, each addition may have its own surrender schedule or it may be subjected to the original surrender schedule with all funds in the annuity becoming surrender-free at the same time. Each contract should be inspected to determine how the surrender charges for additional premiums are handled. While not a withdrawal charge, some states impose a tax on the proceeds disbursed from an annuity, e.g., a lump-sum surrender, and the issuer generally subtracts these state-imposed taxes from the cash value of the annuity prior to remitting to the annuity owner.

Market Value Adjustment

Some annuities also employ a "Market Value Adjustment", or MVA, in addition to a schedule of surrender charges. The MVA adjusts the value of the funds in the annuity for the movement in interest rates between the period the premium was initially paid and when the withdrawal occurred. If interest rates have risen since the annuity was purchased, the issuing insurance company must replace the funds withdrawn from their portfolio with higher priced funds; thus, they impose a penalty, or negative MVA adjustment, on the policyholder by discounting the cash surrender value of the annuity. If, however, interest rates

have fallen since the initial premium, the insurance company can replace the lost funds with cheaper (lower rate) funds and the policyholder is given a positive MVA adjustment or a premium above the cash surrender value of the annuity. The MVA is oftentimes a complicated mathematical formula that is provided in the policy and generally skews the MVA in the carrier's favor, i.e., discounts are more than the rate increase dictates and premiums understate the rate changes.

Penalties

In addition to early surrender charges that are imposed by the issuer, the Internal Revenue Service ("IRS") assesses a ten percent penalty tax on earning that are withdrawn if the owner is under age 59½ at the time of the withdrawal. There are numerous exceptions to the rule, e.g., disability, if taken in substantially equal payments over the remaining life of the owner, if the payments are from a SPIA, etc. The rationale for this penalty tax is that tax-deferred annuities are long term investments that are generally ear-marked for retirement. There is one class of annuities, the tax-shelter annuity or 403(b) that generally has provisions for early withdrawal without penalty. These annuities are reserved for public employees, e.g., school teachers, or employees of non-profit organizations and are not discussed at length in this material.

General Feature & Benefits of Annuities

The various types, or classes, of annuities have unique features and benefits that differentiate them, and we will discuss these later. Annuities, regardless of type, have many features and benefits in general that distinguish them from the other investments available to the saver and investor.

Borrowing from an annuity

A few annuities have a provision that allows the owner to borrow funds from the cash surrender value. Such borrowing generally carries an interest rate that is above the earning rate being paid on the annuity and also must be repaid within a specified time period. The 403(b) type annuity generally contains a borrowing provision that is limited to certain situations, e.g., hardship, purchase of a home, etc. With the exception of the 403(b) annuity, which is always funded in pre-tax dollars, borrowing from an annuity will negate its tax-deferred status. At this time there is no mandate that the issuing insurance company must report such borrowing to the IRS or withhold taxes on borrowings; thus, the owner/taxpayer must self-report such occurrences. As a general rule most issuers do not provide for loans from annuities and most advisors should discourage their clients from using such borrowing if they are allowed, except in emergencies or as a funds source of last resort.

Bonus premiums

In recent years the "bonus premium" or "bonus interest rate" has been a common feature of annuities. Bonuses may be paid for the first year premiums only, the initial premium only, for all premiums for a stated number of years, or for a specific time period. The size of these up-front bonuses range from as low as one percent to as high as twenty five percent, with 4% to 10% the normal range. The "bonus" is an enticement to get the buyer's attention and can result in a higher "holding period" return if (a) the agent receives a lower commission for the sale or (b) the issuer does not re-capture the "up-front bonus" in less generous participation in later years. Even if totally recaptured in later years, the "bonus" does serve a purpose in that it (a) facilitates the sale, and (b) can replace penalties assessed on early withdrawal of funds used for the annuity's premium, i.e., interest lost and penalties charged on the early withdrawal of a bank CD, back end charges from mutual funds in an IRA transfer, or the surrender penalty from an annuity or life insurance policy under a 1035 exchange.

The **premium** bonus is an addition to the amount of the premium and simply increases the size of the initial premium and earns as if it were part of the funds paid by the buyer. The **interest rate** bonus is an addition to the rate of interest (crediting rate) that the annuity earns on the premiums paid. There is a wide variety of conditions associated with bonuses and the reader is advised to carefully review the bonus provisions of an annuity. For example, some bonuses are lost if the owner dies prior to the end of the surrender period, or if owner takes the funds lump sum, i.e., does not annuitize for a certain time period at the end of the surrender period. If the annuity is considered a "walk away," then the client is not required to annuitize the annuity in order to keep the bonus, and if annuitization is required the annuity is generally referred to as a two-tier (discussed later).

Penalty free withdrawals

Most annuities provide for limited access to the money at the option of the owner. A typical provision is to allow ten percent of the value of the annuity to be withdrawn annually without penalty beginning in the second contract year, or a maximum of a certain percent of the original premium may be withdrawn without penalty during the surrender period, or both. Also, required minimum distributions for qualified moneys are generally allowed to be withdrawn free of penalty at any time after the initial premium is paid. The general withdrawal, or liquidity, provisions of annuities vary widely and each contract should be examined to determine the exact provisions, especially if the owner is likely to need access to the money prior to the end of the surrender period.

Many annuities also have free withdrawal provisions of all or some of the annuity funds if the owner and/or annuitant are confined to a nursing home. There may be a waiting period before this provision takes effect and there may

be limits on the amount and/or frequency of withdrawals. Additionally, the policy will provide the exact criteria to meet the definition of a "nursing home" or "convalescent care" provisions that trigger the free withdrawal. Another free withdrawal rider covers the diagnosis of terminal illness of the owner and/or annuitant. Again, the definition of terminal illness is contained in the contract and the amount and frequency of free withdrawals for a diagnosis of terminal illness will be stipulated. Less common in annuities is the free withdrawal of a portion of the annuity value if the owner become involuntarily unemployed. There is generally a waiting period and the amount/frequency of the withdrawals is stipulated in the contract. These riders or provisions in variable annuities are usually assessed a fee to the owner whereas there is generally no charge if contained in a fixed annuity, but may be limited to certain ages.

Spousal option

Most annuities have a spousal option which enables the spouse of the owner, or annuitant in some cases, to keep the annuity in force under the original contract upon the death of the owner or annuitant. This provision continues the tax deferral status of the earnings inside the annuity which is usually desirable if the surviving spouse is not in need of the annuity funds. Also, it prevents the loss of a bonus if the contract provisions stipulate such at early withdrawal upon death and allows the surviving spouse to avoid withdrawal penalties, or a negative MVA, if such is imposed on surrenders following death of the owner or annuitant.

Annuitization

Most annuities can be converted into a periodic income stream after a stated waiting period but prior to the end of the surrender penalty period. For example, annuitization may be allowed at any time after the first, or later policy anniversary following the initial premium payment, provided the period over which the annuitization is taken is at least the minimum stipulated in the annuity contract. Generally, the annuitization options available are the same as those discussed above and range from a period certain to life only and include all the variations previously mentioned.

Taxation

The taxation of payments in annuitization from non-qualified funds (those not in a qualified retirement plan such as IRA, 401(k), etc.) is determined by the "exclusion ratio". The exclusion ratio is computed by dividing the amount of the initial premium by the sum of the payment to be received (determined by the mortality tables for life only pay out options). The exclusion ratio, which will always be less than 100%, is then multiplied by the periodic payment to determine the amount of the payment that is excluded from taxation. The amount that is not taxed, i.e., excluded, is classified as return of principal. Obviously, if the annuity being annuitized contained qualified funds, then all the

income would generally be taxable if the original contributions were made in before-tax dollars. If payment is taken as a lump sum, the increase over the "basis" will generally be taxed as ordinary income. As stated above, premium taxes are imposed by some states and are generally collected during the payout phase.

Sales Loads

Up-front sales charges and other fees are generally not paid on fixed annuities if they are held to term, i.e., the end of the surrender penalty period. If the fixed annuity is surrendered during the penalty period, the surrender charges are sometimes called contingent deferred sales charges. Some index linked fixed and total return annuities do have provisions for the issuers to take part of the earnings as fees under certain circumstances, and these will be discussed later under these classes of fixed annuities.

Variable annuities can have up-front sales charges as well on-going charges for management and other expenses associated with overseeing the portfolio of underlying assets. The sales and on-going charges of variable annuities will be carefully listed in the prospectus and should be reviewed carefully by the financial advisor since they can vary widely among carriers and products. Also, the financial advisor and/or client can generally choose options other than front-end fees, e.g., the advisor's commission may be a trailer fee structure (level or a percent of assets under management over the time the clients owns the annuity) or the client may be subjected to a back-end load which imposes fees when the annuity is surrendered or annuitized. In some cases, both front and back end fees are collected. Generally, the sales charges and options available are listed in the prospectus.

The fees imposed for "riders" vary widely among annuities. As a general rule fixed annuities, including index linked fixed annuities, do **not** impose fees for rider like free withdrawals for nursing home confinement and the diagnosis of terminal illness. Some fixed annuities assess extra fees, generally in the form of lower interest rates or participation rates, for more liberal death benefits, higher guarantees for minimum earnings and other features. Variable annuities generally **do** assess fees for riders such as minimum guaranteed income/death/withdrawal benefits. The advisor should review the fixed annuity agent's manual and the variable annuity's prospectus for such fees and charges prior to presenting to the client.

Aggregation rule

All annuities are subjected to the "aggregation rule". In general, this is a provision of the Internal Revenue Code which says that two or more deferred annuities (not SPIAs) purchased from the same carrier in the same calendar year will be treated for tax purposes as one annuity. The aggregation rule is often

ignored by financial planners, especially those using the financial planning technique called “laddering” for non-qualified funds. This oversight can expose your clients to tax penalties. Remember, contemporary annuities are taxed as last-in, first-out meaning that if a free withdrawal is taken it will be treated as the last addition to the annuity, i.e., interest credited in most cases, and taxed accordingly.

If your client has two annuities funded by non-qualified funds from the same carrier purchased in the same calendar year and withdraws money from only one of them, the IRS has ruled that the amount to be taxed will be determined by the earnings on both annuities. The IRS has declared that Single Premium Immediate Annuities (“SPIA”) are not subject to the aggregation rule.

While “laddering” is not discussed in this chapter, you should be aware that the aggregation rule must be taken into account when using this planning technique.

Minimums and maximum premiums

Most annuities have a minimum and maximum premium amount that is allowed by the insurance carrier. The minimum amount is generally not less than $2,000 and may vary depending on whether the funds are qualified or non-qualified; however, there are major exceptions, especially for 403(b) type annuities, and each annuity should be reviewed to determine the minimum amount. Generally, tax-shelter annuities have a very low amount to start, e.g., $50, and additions can also be small as they are most often taken as payroll deductions by the employer. If less than the minimum amount is submitted to the carrier it is generally either returned or the owner (or financial advisor) is asked to have the owner provide additional funds so the annuity contract can be issued.

The maximum amount allowed is set by the company and it generally varies from $250,000 to $1,000,000 without prior approval of the carrier. The reason for this maximum amount is because the provision of some annuities stipulates that the selling agent’s commission is vested on death and/or the death benefits of the annuity are generous, e.g., full accumulation value, including bonuses, to the owner. Accordingly, large annuity premiums potentially expose the carrier to additional risks they are unwilling to take unless the financial advisor is willing to take a lower commission for the sale. Thus, premiums exceeding the maximum amounts may involve negotiated commissions. Variable annuities are treated more like mutual funds and generally the higher the amount of the premium the lower the commission paid to the financial advisor; thus, maximum amounts may not always be imposed for variable annuities unless the annuity provides for contingent death benefits that expose the carrier to extraordinary risk.

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What are the Different Classifications of Annuities?

Variable annuities

The broadest classification of annuities is between fixed and variable. Variable annuities are securities because as the name implies, their value can vary, positive and negative, from the original amount of premium paid. Variable annuities are oftentimes referred to a "mutual funds inside an insurance wrapper" because, while the earnings are tax-deferred, the underlying assets are the same or similar to those associated with mutual funds, i.e., stocks, bonds, market indexes and general securities. Additionally, the fee structure for variable annuities is similar to mutual funds since they can include an up-front sales charge as well as on-going administrative and money-management fees. In the absence of riders, the variable annuity generally does not carry any guarantees in regard to minimum earnings, death benefits or lifetime income amounts.

Fixed annuities

The fixed annuity's prime characteristic is that it guarantees some minimum earning rate if held for the contractual term, generally defined as the length of the surrender penalty period. The minimum guaranteed growth is most often stated as some base interest rate, e.g., 2.5%, (a) during the period from the initial premium payment until the end of the penalty, and (b) during the total time that the owner holds the annuity in the accumulation phase. It is important to note that some issuers state their guaranteed minimum as a given rate on a percent of the initial premium, e.g., 3% on 90% of the initial premium. It is tempting to conclude that this arrangement would yield a 2.7% minimum guarantee, but doing the math will show a much lower minimum guarantee. As we will see later, the index-linked fixed annuity has many of the characteristics of a variable annuity with respect to the earning opportunity, but it still carries some minimum guaranteed earnings rate if held to term. The fixed annuity has sometimes been characterized as offering a "guaranteed return" whereas the variable annuity offers a "guaranteed opportunity" to realize a return.

Single premium immediate annuity

A narrower classification identifies annuities according to function of how they are funded. For example, the Single Premium Immediate Annuity ("SPIA") involves the payment of a single premium followed no later than one year with a stream of income payment. SPIAs can be either fixed or variable and should not be confused with an annuity that is in the payout phase. While both involve a stream of income payment, the SPIA has no accumulation phase.

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Single premium deferred annuity

Annuities, both fixed and variable, may be "single premium" or "flexible premium". The former is referred to as SPDA (single premium deferred annuity) and the contract allows only one initial premium whereas the FPDA (flexible premium deferred annuity) allows additional premiums after the initial. These additional premiums usually must be at least a certain minimum amount and may be limited to one or more years following the initial premium. Additionally, these additional premiums may "roll forward" the surrender penalty period with each addition being treated separately or the surrender schedule may not be extended for the subsequent premiums with the surrender period for all premiums ending at the same time. Additionally, flexible premiums may each be subject to different interest rates and other earning limitations at the time they are made, or they may be subject to those of the initial premium. The financial advisor is encouraged to review the terms that govern the treatment of additional premiums when using a FPDA.

Tax shelter annuities

A special class of annuities is the Tax Shelter Annuities ("TSA") and is governed by Section 403(b), 457 and others of the Internal Revenue Code. TSAs can be fixed or variable. Generally, TSA are available to the employees of public institutions; school teachers and policemen, as well as those of non-profit organizations; certain hospitals and the clergy. Premiums are paid in before tax dollars, making all withdrawal subject to ordinary taxation. The TSA generally can be opened for a very small amount; $100, and subsequent premiums may also be small. Premium payments are routinely made through payroll deductions. The contribution and withdrawal rules vary widely according to the individual circumstances of the owner. Accordingly, TSAs are viewed as a specialized area of financial planning and those interested in this field are advised to seek information outside this material.

The Single Premium Immediate Annuity ("SPIA")

As indicated above, SPIAs have no accumulation phase and are funded by a single premium that serves as the corpus for a stream of future income payments. One of the payments options available to the owner is selected and the first payment must commence no later than one-year following the payment of the premium. Once the payment option is chosen it generally cannot be changed or accelerated; however, in recent years there have appeared SPIAs that allow for limited changes once the payments start, and may also permit a lump-sum payment for the current present value of the future anticipated income streams.

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The payments of a variable SPIA may change periodically based on the value of the underlying assets: rising when the value of the assets increases and falling if the opposite occurs. As a general rule, fixed-rate SPIAs are most efficient when interest rates are at cyclical or secular peaks because the entire future payment stream is based on the rate in effect at the time of the initial premium. Locking in interest rate peaks assures the highest payout from a given premium. However, since future interest rates are not predictable with any degree of certainty, picking the peak or near peak could prove difficult. Nonetheless, during period of abnormally low interest rates, e.g., the early 2000's, the SPIA is usually not a popular choice. The term structure of interest rates should also be taken into account when using a SPIA in a laddered financial plan.

As was discussed earlier, the amount of the non-qualified SPIA payment that is subjected to taxation will be determined by the exclusion ratio. If the life only option were chosen, the exclusion ratio is determined by referencing the mortality tables and making the computation accordingly. If a SPDA and a SPIA are purchased from the same insurance company during the same calendar year, the IRS has ruled that the aggregation rule is not applicable. The payments of a SPIA can be directed to a third party, and some issuers allow payments to be divided and directed to multiple parties.

SPIAs can be used to fund a future stream of income or they can be used to fund a recurring liability. For example, oftentimes a SPIA is used to make the premium payments of a life insurance or long term care insurance policy. Since there are no adverse tax consequences of taking a SPIA payment prior to age 59½, SPIAs can also be used to fund college expenses, alimony and child support, or any recurring liability that the owner wants to put on "automatic" payment. Also, SPIAs are used in "split or combination" annuities, which are discussed later. Increasingly, the proceeds from reverse mortgages are used to purchase SPIAs rather than taking the installment payments offered by the mortgagee. Since future payments are generally fixed and certain, the owner of the SPIA knows exactly the amount that will be received in future periods. In recent years, some SPIAs have offered as an additional rider the ability to index future payments to inflation. This rider comes at an additional cost and usually has both an annual and lifetime cap.

Even though a SPIA and the annuitization of an existing annuity can provide the same results, viz., a future steam of income, they should be consider separately. For example, a SPIA's future income stream will be determined by the prevailing interest rate, income option chosen and possibly the medical age of the owner at the time the initial premium is paid. The annuitization of an existing annuity generally cannot occur until after some defined waiting period, typically one to ten years after the last premium payment, and may be subject to terms in the annuity contract such as minimum pay out period, minimum guaranteed rate of return, etc. The consensus opinion among financial services

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professional is that SPIAs will undergo a surge in use as the baby boomers move from the accumulation phase of their financial cycle to the distribution, or use, phase. The expected rise in popularity is expected to spawn a new generation of SPIAs that will offer greater flexibility.

It was mentioned before that the income stream available from a SPIA could be linked to the medical condition of the owner-recipient. If a "lifetime" payout option is chose, payment will cease when the owner dies. The sooner death is expected, the greater should be the periodic payments because there will be fewer of them. SPIAs that take into account the medical age of the owner are referred to as "medically underwritten" or "impaired risk" SPIAs because their future payments are increased for shorter life expectancies and decreased as longevity improves. This is just the opposite of how premiums are determined for life insurance policies. Some insurance companies will also increase the lifetime payments for tobacco users as opposed to non-users. It is important to always consider the medical history of a client when a SPIA is considered and, if appropriate, choosing a SPIA issuer that will take the medical condition of the owner into account. Generally, the underwriting is not rigid for smaller medically-underwritten SPIAs but as the amount increases so does the rigor of the underwriting.

Traditional Fixed Annuities

Annuities that offer a fixed rate for a defined period of time are generally called "traditional fixed annuities" to differentiate them from "index linked fixed annuities" (discussed later). A traditional fixed annuity may have a fixed guaranteed rate for a short period of time or it may be fixed for a longer period. Additionally, some issuers mix the two into hybrids that may be fixed for a long time period followed by a period of frequent rate changes, or the initial rate will be increased annually according to a schedule that is made part of the contract. As a general rule, traditional fixed annuities rates are set for one year at a time or are fixed for a multiple-year period.

The one year, or less frequent, guaranteed rates have given rise to the term "trust me" annuities because the owner trusts the issuer to offer a competitive rate at the end of the one-year period. Since the fixed annuity will always have a guaranteed minimum rate, the fixed, or "crediting", rate that is changed periodically must be at least the minimum guaranteed. Other than the minimum guarantee, the owner is at the mercy of the issuer to set a competitive rate and there have been instances where this trust placed with the issuer was misplaced. Some issuers establish "bail out rates" which stipulate that if the renewal rate in any future period is less than the bail out rate, the owner is free to withdraw the funds or 1035 exchange to another annuity with the same or a different issuer without surrender penalty.

Issuers generally announce that they will credit set rates based on prevailing rates or the return they earn on their portfolio for the "bucket" of assets purchased with the fixed annuity premiums funding the bucket. As a practical matter the approach of the issuers is generally eclectic since their earnings outlook must be considered in setting rates for an existing book of annuity business. As a result the term "trust me annuity" is not likely to disappear from use.

Annuities that offer a multiple year rate guarantee, or MYG, wax and wane in importance depending upon the market's perception of the future direction of rates. MYGs gain favor during perceived high rate period and become less popular during cyclical low rate period. MYGs are commonly used if the owner desires a predictable, and fixed, rate of return during the accumulation phase of the annuity. MYGs are used when constructing a split, or combination, annuity or when laddering a portfolio of assets to return a predictable rate of return over a given period.

The split, or combination, annuity is employed when a given amount of money is divided between a SPIA and a MYG in such a fashion that when the SPIA income stream ends the money placed in the MYG will have grown back to the amount used to fund the two annuities. For example:

> A client has $100,000 in a bank CD on which income taxes must be paid every year. By using the exclusion ratio of the SPIA and the tax-deferred earning of the MYG, the money in the CD can be split between the two annuities so that the after-tax income from the SPIA is equal to, or greater, than that from the CD and the MYG will grow back to the original amount of the CD when the SPIA payments stop. Alternatively, the after-tax payment from the SPIA could exactly equal the after-tax income from the CD and the MYG grows to more than the initial value of the CD by the time the SPIA payments end.

In effect, this technique is simply using the tax advantages of annuities to yield the owner a higher after-tax income. Great care should be taken when using the split annuity because with each successive round the exclusion ratio will change and you could leave your client in an inferior position. This technique can be used to structure a series of annuities that can be annuitized to replace the SPIA income and which will maintain the income stream far into the future. For example, you might select a 5 year SPIA, a 5 year MYG and a 10 year MYG. At the end of the 5 year SPIA, the 5 year MYG will have a predictable value and can be annuitized for five years until the 10 year MYG matures. As you can discern, future interest rates may have an impact on annuitization payment; thus, the extended split annuity will involve some uncertainty. During low rate periods, some financial advisors have added to the future uncertainty of split annuities by using trust-me or index-linked annuities in place of MYGs.

Index Linked Fixed Annuities ("FIA")

The index linked fixed annuity is commonly referred to as an equity index annuity, or just FIA. When this annuity was introduced it was linked to an equity index only and thus the reason for the name. As the index linked concept has matured the choice of indices has been expanded to include fixed rate, or bond, indices as well as numerous equity indices, e.g., S&P, DJIA, Wilshire 2000, NASDAQ, and others. It is important to know that the premiums from an FIA are not necessarily invested in equities or bonds, but rather the earning opportunity is linked to movements in the index to which it is linked.

The exact link between the earning potential of the FIA and the index to which it is linked can vary widely among issuers and even annuities issued by the same insurance company. The method used to compute the earnings of the FIA is referred to as the "crediting method" and each method has its own unique set of terms and conditions. In fact, at this time there are over fifty different crediting methods in use and the number continues to expand.

Crediting methods

One of the most popular crediting methods is called the annual point to point annuity and its growth is typically linked to the S&P 500. It works as follows: at the time of the initial premium, the level of the S&P is recorded as the starting point and compared to the level at the first anniversary of the initial premium. The difference is measured and used to determine the amount of the earnings paid into the annuity for the first year. This movement in the S&P may be subject to a participation rate, a cap and possibly a spread. Since FIAs are fixed annuities, the owner is always guaranteed some minimum rate of return even if the index movement is negative over the period. There are also FIAs that will guarantee a certain minimum increase in the index crediting even if the index movement is negative. This guaranteed "index increase" is generally available only for a fee or some other limiting provision incorporated into the annuity's design.

Participation rate

The participation rate is the amount of the movement in the index that the annuity owner is entitled to have credited to the annuity as earning. The participation rate is generally less than 100%. However, in some cases it is stated as 100% participation in an "average", or a "cumulative average", which in mathematical terms is less than a 100% participation rate in the change of the index "point-to-point". The reader should be aware that the use of "100% participation rate" is oftentimes very misleading because it may be based on an "averaging method" or may be subject to a "maximum cap". There are a few FIAs that tout participation rates in excess of 100%; however, these levels may be

illusions as they also have caps, spreads and/or employ an averaging technique to compute the credited earnings. In general, participation rates are higher if an averaging technique is used in the crediting method and lower for point-to-point. Also, point-to-point methods are more likely to employ caps than are the averaging methods. The best way to understand FIAs is by examples.

> Assume the index used is the S&P 500 and this index increases 12% during the year, but the participation rate is stated as 80%. In this case the annuity would be credited with an earning rate of 9.6% (80% of 12%). If the participation rate was given as 100% but with a 9% cap, then the amount credited would be 9% since that is the maximum permitted, or the cap. Sometimes both participation limits and caps are used to determine the earnings credited.

Also, some FIAs employ a fee, generally called the “spread”, which is subtracted from the earning rate before it is credited to the annuity. In the foregoing example, if the spread were 2% the annuity would be credited with 7.6% (9.6% less the 2% spread) and 7% (9% less 2%), respectively. The participation rates, caps and spreads may be fixed for a specified time or they may be guaranteed for the term of the annuity. Generally, if they are subject to being reset at the option of the issuer, they will also include minimum and maximum amounts that limit their variability. The only way for a financial advisor to determine the variables in an FIA is to carefully analyze it and if there is still confusion you should (a) abandon using that annuity or (b) consult with the home office to ascertain the exact terms and conditions.

As indicated, the proliferation of crediting methods have made a very simple concept very difficult and confusing – especially for the client. Commonly used crediting methods include the point-to-point which may be monthly, one-, two- or even three-year(s) in length, the monthly average, the cumulative monthly average with a high water look back and *ad nauseam*. Parenthetically, the high “water mark look back”, or just high water mark, refers to the value being locked in at the highest point during its term if such a point exceeds the minimum guaranteed return. This means that early gains can be “locked in” when the index loses value. Most FIAs guarantee that the annuity value will not decline during a period when the index falls but rather be zero, increase by the guaranteed minimum amount or at the previous high water mark.

The important thing to remember about crediting methods is that any one has a chance of being the best or worse before the fact. Since all are linked in some fashion to a movement in an underlying market determined index that cannot be predicted with accuracy, there is no way to know exactly which one will perform best until after the time period has run. Nonetheless, many financial advisors seem to believe that one, or a few, crediting methods are superior to all others with the annual point-to-point reset being the most popular. It is apparent

that some issuers of FIA have purposely confused the crediting method issue to take advantage of unsuspecting clients and financial advisors; thus, be alert to the fact that some issuers may have structured their crediting methods to afford them unfair advantages.

To debunk the belief that crediting methods are different before the fact, the reader is asked to carefully consider the following: The issuers of FIAs generally do not take the risks associated with linking the earnings rate of the annuity to the underlying index. This risk is assumed, for a fee, by an outside entity that specializes in such risk. The associated cost, or risk assumption fee, is built into the annuity by the issuers and is ultimately borne by the owner. Since the risk arbitrageurs who assume this risk exist in a highly competitive arena, it appears reasonable to conclude that the risk inherent in the various crediting methods is normalized and priced according to the perceived risk assumed by the arbitrageurs.

Also, since annuities are "engineered" by actuaries using the exact same tools, assumptions and cost structures, it seems prudent to conclude that before-the-fact expectations will be essentially the same. Add to the actuarial normality the almost identical cost structure and investment practices of insurance companies and again you would expect identical engineering structures of terms and conditions. Empirical studies have documented that whichever crediting method works best will be a function not only of movements in the index to which the annuity is linked but also the frequency, magnitude and timing of such movement. It is recommended that the reader employ two techniques when selecting FIAs: first, chose the one that is easiest to understand and explain, and, two, diversify the crediting methods by choosing more than one. This diversification can usually be done inside the same annuity as most FIAs allow allocation of funds between crediting methods at each reset date.

At this time the FIA is rapidly becoming the best selling "brand" of fixed annuities as it is promoted to offer unlimited upside potential with no downside risk. FIAs are oftentimes characterized as variable annuities with air bags that protect the annuity owner from market crashes. Since the FIA offers downside protection in the form of a minimum guaranteed rate of return if held to term and participation in the increases of the index to which it is linked, it is the ideal conservative investment for the retirement minded saver who cannot afford loss. The limit on the upside participation is the price, or premium for no-loss insurance, that the owner pays for being immunized against downside risk.

The popularity of the FIA has been bolstered by the recent-year gyrations of the equity and bond markets that have left conservative savers and investors with substantial losses in mutual funds, stocks, bonds and variable annuities. Many of the registered representatives of NASD broker-dealers are now offering FIA as the client complaint level associated with mutual funds and variable annuities has increased. This development has no doubt fueled the recent

activity of the NASD to lobby for regulatory oversight on FIAs, since they have witnessed a loss of market share to FIAs as well as decreased business from their member firms.

The reader is encouraged to frequently review the offerings of FIAs as they are a rapidly changing product. As indicated earlier, the FIA is a simple concept that has been made complicated and confusing by the issuers – at times possibly on purpose but more likely in an effort to quantify the risks to manageable dimensions. One of the major criticisms levied against FIA by the NASD is that the products are not understood by the financial advisors using them. This is likely a valid criticism in many instances and has caught the attention of both issuers and the insurance regulators. Accordingly, some carriers require a certification course in FIAs prior to allowing a financial advisor to offer their products. In all fairness, the same criticisms should be levied against variable annuities as they as just as confusing, if not more so, than FIAs.

Total Return Fixed Annuities

Total return fixed annuities (referred to as TRFAs or “turf-uh”) are very similar to variable annuities as the earnings are linked to the performance of a bucket of underlying assets, invariably equities or fixed rate investments like bonds. TRFAs guarantee a minimum rate of return. The issuer will take a fee, or spread, from the earnings of the underlying assets as their compensation for guaranteeing the minimum return and for managing the assets. Generally, the buyer of a TRFA can select from more than one bucket of assets and is allowed to re-allocate between the buckets on a periodic basis, usually annually. TRFAs generally offer a fixed rate bucket. The allocation limitations and way earnings are credited can be complex; thus, the advisor should document their understanding of each TRFA that is offered to clients. TRFAs has lost much of their market appeal as the FIA has gained acceptance but remains a viable annuity option for some savers and investors.

Variable Annuities

As stated above, variable annuities are sometimes characterized as mutual funds with insurance company wrappers that give them tax deferred status. Like mutual funds, they have up-front sales loads, on-going management and expense fees and their growth, or shrinkage, is linked to an underlying pool of assets. The reader should study mutual funds for better understanding of variable annuities, except be aware that variable annuities offer the same tax deferred features as fixed annuities. Also like mutual funds, variable annuities carry the risk of loss unless the buyer chooses one or more of the riders that prevent or reduce loss. These riders are generally minimum guaranteed death benefit; minimum guaranteed income benefit, and guaranteed withdrawal benefit.

The guaranteed minimum death benefit warrants that generally the value of the annuity upon the death of the owner and/or annuitant will be the highest year-end value reached by the annuity during the holding period. As the decline in equities market of the early 2000's eroded the value of variable annuities, this death benefit became more important not only to the owner and the issuer, but also to outside third parties and the rating agencies. Some of the variable annuity contracts stipulated that the death benefit was the high water mark less the amount of withdrawals from the annuity. For example, assume the variable annuity had a high water mark of $250,000 but the current value is $150,000 and that the owner withdraws, or more likely 1035 exchanges, $140,000. The remaining $10,000 in the variable annuity also has a death benefit of $110,000 ($250,000 less the withdrawal of $140,000). This $110,000 death benefit is an unfunded general liability of the issuer, unless the risk was re-insured.

This unique structure has attracted the attention of investors who are willing to pay the owner more than $10,000 for the variable annuity because it has a large death benefit that will eventually be paid and potentially represents a good investment opportunity if purchased *en masse* to minimize the mortality risk. The regulators and rating agencies have become concerned because of the unfunded liability represents a large potential loss for the issuer. At this time the "secondary market" for underwater variable annuities is developing rapidly. The financial advisor should be aware of this situation for clients who own variable annuities with such death benefit provisions and discourage them from surrendering the entire annuity as that would destroy the death benefit.

Two-Tier Annuities

No discussion of annuities would be complete without mentioning the concept of "two-tier". This brand of annuity can come in any form: fixed, FIA, TRFA, variable or any combination, with or without bonuses and regardless of the age of the owner and/or annuitant. Simply put, the two-tier annuity has two possible outcomes depending upon how the owner takes distribution at the end of the surrender period, i.e., when the annuity's term ends. If a lump sum withdrawal or annuitization of less than a specified number of years is taken, the owner is credited with a lower earning rate than if the proceeds are annuitized for at least the number of years specified in the contract. Additionally, if the annuity paid a premium or interest rate bonus at the beginning, it will most likely be forfeited unless the proceeds are annuitized for the stipulated minimum number of years.

This structure leaves the door open for the owner, and the financial advisor, to be abused in one of two ways: first, if the correct annuitization is not utilized at the term's end, the owner receives a markedly lower earning rate during the holding period and his shortfall accrues to the issuer as added profits. Second, even if the annuitization is taken, the issuer has the latitude of linking the future income payment during annuitization to a below-market rate of interest,

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which has the same effect as paying the lower rate during the accumulation phase of the annuity. Either way, the owner stands to earn a below market rate of return whether he withdraws lump sum or annuitizes. The financial advisor is exposed to criticism for not explaining this adequately to the client, which could have easily been ten years earlier – well beyond the time that the client will remember the disclaimer offered by the issuer and the advisor.

The potential for misunderstanding associated with two-tier annuities has prompted many advisors to refrain from their use. Yet, the two-tier annuity continues in widespread use in the industry. It would be easier to understand, however no easier to condone, if two-tier annuities paid the selling advisor a higher commission, but they do not. This leaves us to wonder if financial advisors recommending two-tier annuities understand the potential negative consequences for their clients.

Who are the most likely candidates for annuities?

By definition fixed annuities are designed for long term savers who are risk averse and can benefit from the triple compounding of this financial product. The variable annuity is not for the risk averse but does offer the same triple compounding as the tax deferred annuity. Early withdrawal can have consequences since there will be surrender penalties assessed, penalty taxes may be assessed by the IRS in certain situations, and the earnings become subject to ordinary taxation. Obviously, a client planning for retirement should first maximize contributions to qualified pension plans as this is generally done in pre-tax dollars and is often accompanied by matching money from employers. Arguments have been made that the inability of take advantage of capital gains taxation (usually made in discussions of variable annuities) have been offered as reasons not to purchase annuities; however, empirical analyses indicates that their shortcomings pale when compared to the deferral of taxes until the funds are withdrawn.

Those using annuities for retirement planning can choose when they take disbursements and pay the taxes. There is no limit on the amount of money that can be placed in a tax deferred annuity nor are there requirements that the fund be withdrawn at any given future time. Annuities offer a way to reduce the taxes that are paid on Social Security benefits because as long as the money is in deferral- the accumulation period- it is not reportable income when computing the portion of Social Security benefits that are subject to taxation. Also, annuities are the only financial product that can be turned into a lifetime income – an income that cannot be outlived and future income payments that are unconditionally guaranteed by an insurance company.

Annuities are also appropriate products for **conservative savers who are already in retirement** but want to safeguard their principal and have an opportunity to earn a market rate of return on their savings. By carefully choosing traditional fixed, FIAs and TRFAs the cautious saver can craft a diversified portfolio that can be managed virtually risk free and defer all taxes until the funds are withdrawn as needed. It should be realized by both savers and their financial advisors that annuities, not even FIAs or TRFAs, are expected to return the same as a well diversified equity or mutual fund portfolio over a long period of time because of the immunization against loss. However, there is ample evidence to support that the rate of return on fixed annuities, especially on FIAs and TRFAs, eclipse the earnings from taxable fixed income savings products like bank CDs, Treasury Bonds and other fixed rate conservative investments.

There is a raging controversy over whether or not annuities are appropriate for IRA and other qualified funds. The opponents argue that these investments already have tax deferral and putting them into annuities would be double kill. This overlooks the most important attribute of an investment or saving account: what is the rate of return? Does it really make any difference whether or not you have superfluous tax deferral if the rate earned beats the next best alternative of the same risk level? If an annuity can return a higher holding period yield than a bank CD, mutual fund or any other investment, then it is appropriate for qualified money because the owner will have a bigger nest egg at the end. Likewise, if the annuity protects the owner from downside risk that otherwise cannot be afforded, it offers the owner "sleep insurance" that other investments cannot and is appropriate for qualified money. Additionally, an annuity is the only investment that can provide an income that cannot be outlived, and this may be important to a client who fears outliving their money.

If clients only knew

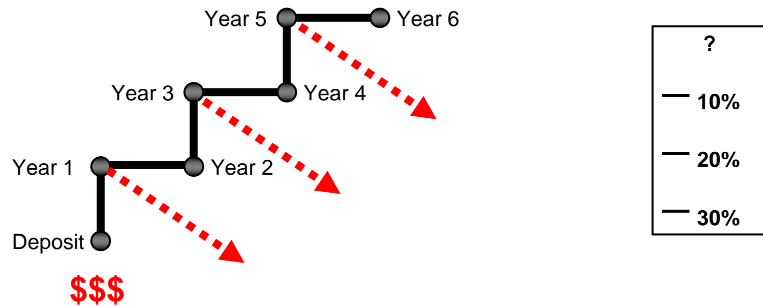
If our clients only knew that the stock market was going to have a significant decline from 2000-2002 would they have chosen to reposition investments with no protection into some sort of an annuity (probably an FIA) due to the principal protection and potential for good upside growth.

5-year historic review of the S&P 500

- 14.71% (2003)
- -22.09% (2002)
- -11.88% (2001)
- -9.10% (2000)
- 21.04% (1999)

The average rate of return over the five year window was a negative1.45%.

If we only knew, we all would have moved some or all of our money to principally guaranteed annuities (this also includes money in 401(k)/profit sharing plan or IRA). The following is how a typical annual point-to-point annuity protects a client's invested money from downturns in the stock market.



In year one if the measuring index goes up, so does the value of the annuity. If in year two the market goes down, it does not affect the value of the annuity. This is an annual reset that will always guarantee that the client's money will not go backward in years when the stock market does not perform well.

	$100,000	**$100,000**
	Invested in S&P	**Invested in FIA**
Year	**A**	**B**
1 (1999)	**$114,710**	**$112,000**
2 (2000)	**$89,370.56**	**$112,000**
3 (2001)	**$78,753.34**	**$112,000**
4 (2002)	**$71,586.78**	**$112,000**
5 (2003)	**$86,648.64**	**$122,080**

A good saying for clients when the market goes negative is that "**zero is the hero**." As you can see by years 2-4, if the investment return was zero (something most investors do not like), the client would have been very happy. Annuities, and FIAs specifically, are not the perfect investment, but it is very easy for clients (especially those getting near retirement) to justify having some portion of their investment portfolio inside an investment that will not go backwards. Again, if we only knew, wouldn't we all have had some of our money in principally guaranteed investments from 2000-2002?

What's new with Annuities

Learn How Clients Can Earn Significantly more with the NEW FIA/FIA Guaranteed Living Benefits (GLB) Rider

Would your clients like a guaranteed rate of return in their Fixed/Equity Indexed Annuity of 7%? (Based on an accumulation vs. withdrawal value).

Would they also like to receive a "guaranteed" income benefit based on the accumulated account value that is the best and most flexible in the industry?

With much of our population moving from an "accumulation" phase of their lives to an "income" phase, clients are much more interested in having a "guaranteed" income for the rest of their lives vs. being interested in growing their wealth at a high rate of return.

What is a (GLB) Rider in the context of a FIA?

A GLB contract "rider" is issued by an insurance company that "guarantees" a regular monthly, quarterly, or annual payment for a client's lifetime, even if the account balance of the FIA does not support the income stream.

Example: Suppose you had a client who was 61 years old who invested $100,000 in a FIA with a 5% lifetime income benefit rider. If the client activated the rider, the insurance company guarantees a withdrawal of $5,000 per year for the rest of the client's life (no matter how long he/she lives), even if the account balance does not have enough money in it to support the stream of income.

Newest developments

One insurance company has come out with a very interesting way to account for the GLB. Generally speaking, the GLB riders currently available provide a guaranteed income via the following schedule.

-5% if the contract is issued before age 70
-6% before age 80
-7% over 80 years old

Therefore, if a client had a $100,000 in a FIA, he/she could receive "for life" $5,000 a year if the contract is issued before age 70 and activated at age 70 or older, $6,000 if the contract is issued before age 80, and $7,000 if issued after age 80.

Great, right? It's not bad although the schedule seems a bit inflexible doesn't it?

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Think about it. A client who is age 79 receives the same payout as a client who is 71 years old (6%). That doesn't seem quite fair does it? For a client that is age 81, the payout will never be more than 7%.

A new "fairer" payment schedule

Let me just state how the payment schedule will work for this new kind of GLB rider and then give a few examples, and you'll see why your clients will like it much better than what's currently in the marketplace.

The client will receive as a GLB (guaranteed income for life) a payout rate of 1% less than their age. It sounds simple enough.

-If a client is 60, the payout will be 5%
-If a client is 65, the payout will be 5.5%
-If a client is 75, the payout will be 6.5%
-if a client is 85 when triggered, the payout will be 7.5%
-if a client is age 90 when triggered, the payout will be 8%

Very interesting isn't it? Why? Because this new approach to GLB riders puts a client in a position to get paid significantly more than the more rigid approach that is currently prevalent in the marketplace.

Let's look at an example for a 79 year old with $500,000 in a FIA with a GLB rider. With most of the current products in the marketplace, the client is going to receive a GLB of 6% a year for life.

The income for this client using a normal FIA with a GLB rider would be $30,000 a year.

What about with the fairer GLB? The client would receive a GLB of 6.9% (1% less than his/her age).

The income for this client using a normal FIA with a GLB rider would be $34,500 a year. With the more client friendly product, the client received $4,500 more income every year for life. If the client lived another 10 years, that's an additional $45,000.

Income is based on the "accumulation" value

The payouts outlined above (and the 7% guaranteed rate of return) are based on the calculated "accumulation" value of the FIA NOT the actual "account value." The account value is whatever the actual value of the annuity is at any given time based on product design and annual market rates of return.

The account value is what the client would receive if they wanted to cash in the annuity.

The accumulated value in these products is based on a predetermined number set by the insurance company. Most companies have a "guaranteed" accumulation value of 4-5%. The new annuity coming out has an accumulation guarantee of 7%.

There is a huge difference between a guaranteed accumulation value of 5% and 7%. For example, if a client, age 50, positioned $500,000 into the new FIA with a 7% guaranteed accumulation value, that value at age 70 would be $2,070,281. If the client used a FIA with a guaranteed accumulation value of 5%, that value would be $1,392,981

Look how that will affect the income benefit at age 69:

With the more client friendly FIA the client's guaranteed lifetime income would be 5.9% x $2,070,281 = $122,146 ever year until death.

With the some of the other products currently available the client's guaranteed lifetime income would be 5% x $1,392,981 = $69,649 ever year until death.

The difference is staggering; $122,146 - $69,649 = $52,497 every year.

If our 69 year old lives until age 79, that's $524,970.

When is a <u>7%</u> guaranteed return better than an <u>8%</u> guarantee?

The simple answer is that 7% is better than 8% when the guaranteed **<u>income</u>** from a 7% guaranteed return product is higher than an 8% guaranteed return product.

How can that be; and, does the previous sentence make any sense?

As stated earlier, there are two components to FIAs that guarantee a 7%-8% rate of return (accumulation value) and an income stream for life. They are:

1) The rate of return on money as it accumulates (8% is, in fact, greater than 7%).

2) The rate of return used to calculate the income for life (this varies greatly by company)

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Is the client really interested in the rate of return? Or is the client interested in the maximum income benefit in retirement? **Income in retirement.** And, they really could care less what their "guaranteed" rate of return is.

Let's look at how the income stream for life is calculated and you'll then know how a 7% rate of return can outperform an 8% rate of return.

Income at age	GIB with client friendly product	Income w/ 7% Roll-up	GIB with non-client friendly product	Income w/ 8% Roll-up
60	5%	**$9,835**	5%	**$10,794**
64	5.40%	**$13,924**	5%	**$10,794**
65	5.50%	**$15,174**	5.50%	**$11,874**
69	5.90%	**$21,337**	5.50%	**$11,874**

What do you notice about the above chart?

Look at the percentage used to generate the guaranteed income at the various ages. At age 60, both companies have a 5% income benefit.

At age **64**, the FIA I prefer has a **5.4%** income benefit and the other product still has a **5%** income benefit.

Therefore, unless the client activates his/her income stream right at age 60, the income from the FIA I prefer will be higher.

Now let's look at age **65** and **69**. There is a huge income difference in the two products. Why?

Because the client friendly FIA has a **guaranteed 20-year accumulation roll-up**. The competitor's product on the right has a **10-year accumulation roll-up**. In year 11 there is no guarantee of 8% (I've assumed the worst case scenario that could happen which is no growth due to a low account value over the first 10-years).

Therefore, the client friendly FIA not only will generate more income for your clients, it will also generate significantly more "guaranteed" income due to the 20-year accumulation guarantee.

Which FIA do you think your clients will like better? Of course, the one that is fairer and the one that gives them the **maximum flexibility** to receive the **maximum income** benefit when they choose to receive income for life.

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The bottom line is that you have to know all the options in the marketplace in order to provide the best advice to your clients. The WPI does the best it can to keep the course material up to date, but you too should do everything you can to keep on top of the best products available to help your clients.

Helpful Questions and Answers:

Question—When does the income benefit kick in?

Answer—When the client requests that income begin (and the value of the FIA on that date will drive the income benefit).

Question—Can the client receive more money from their guaranteed income benefit if the FIA increases in value during the payout phase?

Answer—Yes. It is likely that the guaranteed income benefit will increase if the S&P 500 early on in the payout phase returns more than the income benefit.

Question—Does the client have to "annuitize" the FIA in order to get the guaranteed income benefit?

Answer—No. If clients want to take distributions from the FIA they still can (although this will lower they guaranteed income benefit going forward).

Question—What extra cost is there for the client when this “rider” is added to the contract?

Answer—It depends on the company, but the going rate seems to be between.4% (.oo4) to .75% (.0075) of the client’s annual returns. So, if the client used an annual point-to-point crediting annuity with a cap of 8%, the returns on an annual basis would be minus .4%-.75%. If the S&P 500 returned 7%, the client would be credited with 6.6%-6.25% depending on the product.

Question—Do these types of riders make sense with an FIA which already guarantees that the client will never lose money when the market goes down and where most FIAs lock in investment returns on an annual basis?

Answer—This is a tough one. I tabled this out in an excel spreadsheet and the answer is it depends. If the market returns in the above example average more than 5% a year while the client is receiving annual guaranteed payments, the client would have been better off simply taking withdrawals from the annuity. Why? Because of the fee with the rider.

What's the bottom line with FIAs that have "guaranteed income benefits?"

They should be used if a client who is 60 years old or older and wants to have certainty when it comes to an income stream. If you table them out over the long term, the client will be better off allowing the money to grow each year in the FIA and taking withdrawals (this assumes the average rate of return inside the FIA is higher than the guaranteed rate over the lifetime income period).

For more information on these riders and how they compare to guaranteed income riders on variable annuities, please e-mail info@thewpi.org and request a 33-page white paper that compares the two products.

Summary

Annuities come in many varieties, classifications and versions, but they all have in common the feature of tax deferral. Annuities have a place in the financial plans for a large percentage of the individuals who are saving for retirement or are already in retirement, and who cannot afford to take the risk of losing some or all of their investment. Annuities are the only investment in the financial advisor's tool kit that offers triple compounding, free immunization against downside risk, zero up-front sales fees, the opportunity to earn a competitive or better rate of return, and can be converted into an income that cannot be outlived.

While annuities are not for everyone, they are appropriate for conservative savers who cannot afford market or interest rate risks and can use the tax deferral features to minimize, or better manage, their tax liability. Annuities are appropriate for both qualified and non-qualified money if the after tax rate of returns are acceptable when measured against comparable options. The argument against using annuities for qualified funds because of the superfluous tax deferral misses the *raison d`etre* of an investment: the rate of return.

For readers who do not usually give advice on this topic, now you can see why having a working knowledge of annuities is a must when providing estate planning, tax planning or financial planning advice to clients.