Investors & Objectives

4

Why do people buy annuities? It's a fundamental question every salesperson asks. In this chapter we'll explore various types of clients, their needs, financial objectives and other factors that go into the decision to purchase an annuity.

Annuity Investors

While it is cliché to state that all clients are unique — and indeed all investors have unique needs and face different circumstances — annuity investors can be classified into four broad categories:

- individual investors,
- trusts,
- charities, and
- corporations.

Individuals

Over the course of a human lifetime, an individual's investment objectives will typically pass through four phases: accumulation, conservation, distribution and transfer. In one's younger years, the focus in on accumulation of wealth. Whether it is scraping together a down payment to purchase a first home, putting those first contributions into one's retirement account or setting aside funds for the children's college fund, the goal is to accumulate capital and investments are typically made with capital appreciation in mind. As the investor ages, the objective shifts from appreciation to conservation — riskier investments that might yield significant investment gains give way to less-risky investments offering safety of principal. As one's working years end, the objective becomes how to assure that the wealth that has been accumulated and conserved can be used to support the investor in retirement. At the end of one's life the focus is how best to pass on one's wealth to designated beneficiaries.

Let's take a look at how annuities (fixed, variable and indexed) can help individual investors in achieving these objectives.

Accumulation

Historically, equity investments offer the greatest possibility of capital appreciation. The term "equity", meaning ownership, encompasses a wide range of investments. It could refer to owning a small business, owning real estate or other tangible assets, or participating in the ownership of large corporations through the purchase of the company's common stock. Equities have tremendous upside potential. Everyone has heard of stories of an investor who purchased 100 shares of a promising start-up company and watched their investment grow into millions of dollars. But it is also true that many investors have put money into companies that have not performed as well, or that have gone out of business. There is a significant risk-reward component to investments in equities. Investment advisors must certainly take into account an investor's tolerance for risk in meeting the objective of capital accumulation. Rather than simply investing in vehicles that offer the possibility of capital appreciation, investors should invest in a manner that maximizes the probability of achieving his or her goals. This may entail investing in a range of riskier and less risky assets — this is the underlying principle of Modern Portfolio Theory.

In the annuity market, investors seeking capital appreciation have two options: variable annuities and equity indexed contracts. Each offer different advantages and disadvantages to investors.

Variable Annuities

As we discussed in earlier chapters, the investment performance of a variable annuity relies on the investments held in a variety of separate accounts. The contractholder in a variable annuity will select which subaccount(s) he or she would like to invest in. The value of the subaccount will fluctuate in value based on the current values of the investments held within the subaccount. Typically, the subaccounts invest in common stocks, with the expectation that common stocks offer better inflation protection for the investor — but as with any equity investment, there are no guarantees. The contractholder assumes the investment risk in a variable annuity.

Modern Portfolio Theory holds that the best way to achieve the highest possible returns with the least possible amount of risk is to invest in a broadly diversified portfolio that can be rebalanced periodically in response to changing market conditions (preferably with little or no transaction costs). Variable annuity separate accounts (or investment in a combination of various subaccounts) offer the investor a way to create a broadly diversified portfolio. Most variable annuities today offer a wide range of subaccounts to their contractholders. Each subaccount is a professionally managed portfolio — some are actively managed; others are passively managed. Some variable annuity companies have an exclusive arrangement with a particular money management firm to make investment decisions for its subaccounts. Other companies may offer contractholders a choice of subaccounts managed by different advisory firms. Obviously, the portfolio managers need to be paid, so all of these investment alternatives come at an expense. Almost all variable annuity contracts also will offer a "fixed subaccount" with a low guaranteed rate of return, which acts much like a fixed annuity within the variable annuity contract — and this fixed option comes without any management fees.

It is worth noting that sometimes a variable annuity's subaccount is referred to as a "clone" of a well-known mutual fund. This term can be misleading. For example, a variable annuity may offer a subaccount called the "Stellar Growth Opportunities" managed by Nova Capital Management. Nova may also offer a mutual fund by the same name — but this does not guarantee that the subaccount and the mutual fund are managed by the same person, have the same investment objectives and policies, or share the same underlying investments. Nor does it mean that the fees and expenses are the same. Even in cases when the same professional manages both the variable annuity subaccount and the mutual fund that manager may employ different investment strategies. Tax considerations alone may account for different strategies: mutual funds must distribute capital gains to shareholders annually (which are taxable regardless of whether they are reinvested in the fund or not), while gains realized in the variable annuity's separate account are not distributed. Another difference between the separate account and the mutual fund is in the calculation of the unit or share price. Realized gains in a variable annuity's subaccount are automatically "reinvested" in the account, i.e., realized gains are reflected in the growing "price" of a fixed number of accumulation units. By contrast, realized gains that are distributed and reinvested in a mutual fund are used to purchase additional shares — in other words, the number of shares (not the price) will increase. For these reasons, advisors should refrain from describing a contract's separate account as a "clone" of a mutual fund as it could potentially mislead clients.

According to the Modern Portfolio Theory an investor should invest in a broad portfolio of securities that have weak correlation, that is, they do not behave in lockstep. Ideally, the portfolio will contain some investments that go down while others in the portfolio go up, and vice versa. The assumption is that by holding weakly correlated securities, the investor's risk is reduced, in other words, the investor is protected in good times and bad. Put another way, it is not enough for an investor to diversify his or her portfolio by owning a large number of stocks, but must also invest in different types of stocks that behave differently as the market changes. This is called the "**efficient portfolio**". A sophisticated investor can construct an efficient portfolio by selecting individual stocks, but trying to build an efficient portfolio by combining separate accounts is a more daunting task. In most cases the statistical data to analyze separate accounts for this purpose (expected mean returns, expected volatility, coefficients of correlation, etc.) are not readily available. Fortunately, advisors can use separate accounts with different investment policies as a "proxy" for an asset class, e.g., Nova's Stellar Growth Opportunities as a proxy of small cap stocks in general. As an oversimplified example, an advisor could recommend investing in a separate account that invests in cyclical stocks in conjunction with a subaccount holding countercyclical stocks. The two asset classes should move in opposite directions during the business cycle, and thus approximate an efficient portfolio.

When combining separate account portfolios in this way, it is useful to make the distinction between actively managed portfolios and those that are passively managed. By definition, **actively managed portfolios** attempt to outperform the market. This, after all, is what sells the fund to investors and justifies the management fee. However, actively managed portfolios may also fail to match the investment results of the general market. Advisors relying on the Modern Portfolio Theory to construct an efficient portfolio for his or her client will want to seek out funds that mirror the results of a particular asset class. Actively managed portfolios most likely will not meet that need — as the goal of the active manager is to exceed, not to simply match, the market. Advisors seeking to build an efficient portfolio within the variable annuity may want to explore **passively managed portfolio** options within the contract — as these are more likely to achieve the results the advisor is seeking. Passively managed portfolios are designed to match the performance of a market benchmark, such as the S&P 500. For instance, Nova's "Russell 2000 Index Growth" account is more likely to match the overall investment results of small cap growth stocks, in general, than Nova's actively- managed "Stellar Growth Opportunities" which is trying to beat the general market.

In the past, most variable annuity contracts did not offer many passively managed subaccount choices, but there seems to be a trend toward offering more of them. Some contracts now offer Exchange Traded Fund accounts (ETFs), such as Spiders® and Diamonds® which mimic the results of the S&P 500 and Dow Jones Industrial Average, respectively. Either of these options (passively managed subaccounts or EFTs) will have lower expense ratios than their actively managed counterparts.

For advisors who feel that actively managed portfolios offer added value to their clients (even at the higher expenses) variable annuity contracts may offer the ability to select specific managers or specific management styles to enhance their client's portfolio. Some firms have a "total value investing" philosophy; others focus on growth only. Some firms are expert at fixed-income investments; other concentrate on equity investments. Put another way, a range of actively managed subaccounts allow the advisor to diversify the portfolio not only by investment type but diversify management expertise as well.

One last aspect of Modern Portfolio Theory is that an efficient portfolio should be rebalanced periodically — to return the investment mix back to it's original percentage allocations, or to reflect changed investment objectives and time horizons — preferably at little or no cost. Variable annuities typically allow switching funds among subaccounts without cost. Given the tax-deferred nature of annuities, such switches are not taxable events (as they would be in a mutual fund family) — so variable annuities offer a very cost-efficient means to rebalance a portfolio. Many variable contracts offer to automatically rebalance an investor's holdings on a regular schedule (annually, quarterly, etc.) or if the percentage allocation varies from a target by a predetermined amount. This automatic rebalancing is usually provided at no additional charge to the contractholder.

A similar feature, offered by many contracts, is a dollar cost averaging program. This allows an investor to invest a lump sum without fear of investing at the wrong time. The company accepts the full lump sum into the contract’s fixed account and periodically transfers a predetermined dollar amount into the selected variable subaccounts. This has the advantage of purchasing more units when the unit price is low and fewer units at higher prices. The entire sum is transferred evenly over a period of time, usually six months or one year. Mathematically, a dollar cost averaging program will buy units at a lower average cost than the average price of the units over that period.

Indexed Annuities

Indexed annuities, in contrast to variable annuities, do not rely on separate subaccounts of investments. Instead, the annuity issuer guarantees a rate of return based on an equity index, subject to limitations stated in the contract. Put into the context of the proceeding discussion of Modern Portfolio Theory, indexed annuities offer investors a passively managed alternative to the choices presented within variable annuity contracts.

It is important to note that an investor who selects a passively managed subaccount in a variable annuity that mirrors an equity index (e.g. Nova's Russell 2000 Index Growth fund, mentioned above) is subject to investment loss if the index falls. That is not true in the case of indexed annuities. The company issuing an indexed annuity does not actually hold a portfolio that is representative of the index. Instead the issuer will purchase index options. This allows the company to participate in the upside in the market, but not to suffer losses if the market falls. (The contractholder bears the cost to purchase the options by accepting limitations on how much of the index's gain will be credited to the contract. Equity indexed annuities are not a "free lunch" program.)

Thus, the key difference between an investment within a variable annuity and an equity indexed annuity, from the investor's perspective, is that the investor is subject to the full investment results, up or down, that occur in the variable annuity's separate account (net of the management fee), while investors in an indexed annuity will participate only in the upside of any index moves, but those gains are limited by contractual features such as participation rates, caps, spreads, resets, etc. In a way, indexed annuities straddle the investment objectives of accumulation and conservation — which no doubt, accounts for their popularity for a wide range of investors.

As noted in Chapter 1, the index used in most equity-indexed contracts is the S&P 500 index. This index only reflects changes in the share prices of the index's component stocks — it does not include dividend payments made by those stocks. So the "market return" in an indexed annuity contract will probably not match the total return an investor in an indexed separate account (mutual fund or EFT) would earn.

Conservation

The second investment objective most investors have is conservation. Accumulation is the process of acquiring capital; conservation is the process of keeping it. This is the natural consequence of the aging process. Accumulation of capital — and the risk that entails — begins in early years when the investor's investment horizon is reasonably long. As we age, that timeframe inevitably shrinks. The time available to recover from investment losses diminishes, so the focus of the investor changes to retention of the capital that has been acquired. "Safety of principal" sums up this objective.

While poor investment performance is the most obvious reason for loss of capital, losses can also arise from a variety of other reasons: taxes, insolvency of the institution holding the investment, or attacks by creditors. Annuities, of all types, can assist an investor in meeting the objective of conserving capital.

Fixed Annuities

Fixed annuities, which offer a guarantee of principal, are the most obvious choice for those seeking conservation. The investor's principal is paid to the company, and the company invests those funds in its general assets. The company must pay the investor the guaranteed rate of return, regardless of the investment results earned in the company's general assets. In a fixed annuity, the company issuing contract bears the investment risk, the investor's principal is guaranteed.

As with all annuities, growth in the fixed annuity investor's account is tax-deferred. In many other investments, such as stocks and mutual funds, periodic distributions of income are subject to taxation. These periodic distributions can, in many cases, be reinvested (automatically or "manually") and the investor can experience compounding interest — earnings on earnings. In a taxable investment, only the after-tax portion of the distribution can be reinvested, or compounded. In a tax-deferred annuity, all earnings are available for compounding. This is sometimes called "triple compounding" — the principal earns interest, the interest earnings interest, and the portion that would have been payable to the taxman earns interest. Fixed annuities, during their accumulation periods (when accumulation and conservation are paramount) are very tax-efficient. (As we'll see later, annuities may not be as tax efficient when proceeds are distributed during the annuity period.)

All investors should be aware of the extent to which they may lose money as a result of the bankruptcy (or other failure) of the institution that holds their money. Advisors can use the ratings organizations discussed in the previous chapters to assess the current financial strength of insurers and annuity companies. In addition, state regulations require issuers of annuities to maintain adequate reserves based on standard actuarial assumptions. That said, assets held in the general assets of an insurance or annuity company are subject to the claims of the insurer's creditors (including the contractholder). Advisors must be aware, and be careful to disclose to clients, that insurance and annuity companies are not depository institutions in which accounts are federally insured. Implications to the contrary are considered by state regulators to be serious misrepresentations of the contract and could result in revocation of the advisor's insurance license. All states do have "guarantee funds" to reimburse owners of life insurance policies and annuity contracts for losses resulting from an insurer's insolvency. Florida's Life and Health Guaranty Association provides coverage of up to $300,000 per life or health policy ($100,000 cash value) and $300,000 for fixed (but not variable) annuity contracts. Florida law prohibits agents from referring to this protection in their sales presentations.

Annuity contracts of all types, in Florida, are provided special protections against creditor claims. These are discussed later in this chapter.

Indexed Annuities

Much of the foregoing discussion of fixed annuities applies equally to equity indexed annuities — from a purely regulatory perspective, indexed annuities are fixed annuities. Unlike traditional fixed annuities, indexed annuities offer the opportunity to participate (albeit partially) in the upside of market advances while protecting the investor from the downside. In that regard, equity indexed annuities have tremendous appeal to investors concerned with conservation of principal.

Variable Annuities

As discussed above, variable annuities subject the investor to the possibility of investment losses due to poor investment performance. As the variable annuity investor's objectives change from accumulation to conservation, the investor can switch from subaccounts that aggressively pursue capital growth to other, less risky subaccounts. While that may mitigate losses due to poor investment management, it will not eliminate it — investments tied to the stock market will inevitably feel the effects of a severe market downturn regardless of the expertise of the manager. Newer variable annuity contracts contain several risk management features from which the investor may choose (at an additional premium) to lessen the effects of a bear market:

- guaranteed minimum accumulation benefit (GMAB),
- guaranteed minimum income benefit (GMIB), and
- guaranteed minimum withdrawal benefit (GMWB).

Newer combination riders, incorporating all three "living benefits", provide all of these assurances with greater flexibility. These three riders were discussed in greater detail in Chapter 1.

Variable annuities also provide a minimum guaranteed death benefit, in effect protecting the investor's principal for the investor's beneficiaries, regardless of the investment experience in the subaccount. Enhanced death benefits can provide addition protection, for an additional fee.

As was the case with fixed annuities, variable annuities grow tax-deferred. During the accumulation period, earnings in a variable annuity's subaccount grow through "triple compounding" of interest. This is one of the key features of deferred annuities — and as long as the principal remains in the contract, the tax deferral works to the advantage of investors seeking to conserve principal.

Regarding the insolvency of the issuing company, an investor in a variable annuity is in a distinctly different position than a fixed annuity holder. Investments within a variable annuity's separate account are, as their name implies, separate from the general assets of the issuing company. The separate accounts are not subject to the general creditors of the issuing company. In other words, the assets held by the separate account are reserved exclusively for the investors in that separate account. There is, of course, no guarantee that the assets in the separate account will fully reimburse the accountholders — but, at a minimum, there will be assets dedicated solely to the separate accountholders. It is important to note that there is no legal mechanism such as a state Guaranty Fund to reimburse variable annuity holders, nor are variable annuities subject to the reserve requirements that apply to fixed annuities. Simply put, the only thing backing the investment in a variable annuity issued by a failed company is the portfolio held by the separate account(s) selected by the investor.

Inflation risk

The foregoing discussion assumes that the conservation of principal is in constant dollars. Rarely in the real world, however, is that the case. In recent history, the American economy has experienced purchasing power loss (sometimes mild, at other times severe). If the rate of return from the annuity contract (fixed, indexed or variable) is less than the rate of inflation, then the investor is not truly conserving capital. Even modest rates of inflation applied over a long time can significantly erode the purchasing power of the initial pool of capital.

For investors concerned with conservation of principal, inflation is a serious concern. This, after all, was the reason variable annuities were developed in the first place. Variable annuities, with investments in equity securities, provide a better hedge against inflation risk than traditional fixed annuities — albeit with a greater exposure investment risk. Equity indexed annuities, with the minimum guaranteed value plus participation in market gains, perhaps provide the greatest protection for investors seeking to conserve the purchasing power of their capital.

Distribution

At some point in the investor's lifetime, the investment objective will change from acquiring and conserving wealth to distributing it. Some assets are easier to liquidate than others. Real estate and ownership interests in small business can be particularly difficult to liquidate. Annuities, by their very nature, are designed to provide a stream of income. Annuities — fixed, indexed or variable — are the only investment options that can be converted into income payments lasting lifetime. The concept of an income that cannot be outlived has given comfort to many investors. In addition to the possibility of annuity payments, annuity contracts may also be liquidated, in whole or in part, during the accumulation period. (Once the contract is annuitized, however, the contractholder loses this option.) Large withdrawals in the early years of the contract will most likely be subject to surrender charges, although most contracts will allow penalty-free withdrawals up to 10% of the account's value. In addition, withdrawals from deferred annuities prior to 59½ face a 10% tax penalty. With those caveats, for investors concerned with distributing wealth during their lifetimes, annuities are an ideal investment.

Fixed annuities

Fixed annuity payouts provide a guaranteed income stream, paying a fixed amount periodically. The size of the payout depends on the value in the account, the interest earned in the contract and the projected actuarial length of the payout period. The fixed nature of the payments can be an advantage or not. Fixed annuities are the only situation in which income is guaranteed for the length of the payout period (usually a lifetime), but the fixed payments are subject to purchasing power risk.

A few (very few) insurers offer contracts that have a true **cost of living adjustment** tied to an external index of inflation (such as the Consumer Price Index, or CPI). Some insurers do offer fixed contracts in which the annual payout is increased be some stated percentage, usually 1-3%. This may or may not be enough to offset inflation. For the inflation fearful, this feature may be better than nothing, but it is probably not what they would prefer. Advisors should be aware that the initial annual payout for annuities containing an adjustment factor will be less than that of a traditional, fixed payout. The greater the guaranteed annual increase, the greater this difference will be. And often these types of contracts do not contain all of the features that might be offered by the issuer's traditional fixed contracts.

Variable annuities

Variable annuity payments are not guaranteed. They, instead, fluctuate based the investment experience of the selected separate accounts. The intent is that, over time, the payments will increase to offset the effects of inflation — but this is a not guaranteed. For those concerned with inflation protection, the current choices are variable annuities (which may perform better or worse than the inflation rate) or inflation-adjusted fixed payouts. The decision is a personal one, based on expectations for future inflationary trends and the degree of protection the investor desires. Many retirees will want to "do better each year" (in real dollar terms), and for these investors, the variable annuity may make more sense.

Riders such as the minimum guaranteed withdrawal benefit (MGWB) and minimum guaranteed income benefits (MGIB) discussed in Chapter 1 could also allay fears over declining variable payouts. The MGIB links variable annuity payments to a guaranteed benefit base that is unaffected by losses within the annuity's separate account(s). This benefit comes at an additional cost: there is a premium for the rider, and usually the rider requires annuitization using payout factors less attractive than those available to contractholders who do not elect this benefit. The GMWB provides similar protection against downside market movement if the contractholder wishes to periodically withdraw funds from the account prior to annuitization — again, at an additional cost.

For investors in variable annuities who wish to have the guaranteed income of a fixed annuity, most variable contracts will offer that as an option. If a variable contract does not have that option, the investor can exchange the contract tax-free under Section 1035 for another contract that does offer a fixed (or an inflation-adjusted) payout.

It is important to note that all annuity contracts contain a guaranteed payout schedule at the time they are issued. In many cases, those guaranteed schedules result in annuity payments that are less than could be obtained from newly-issued contracts for immediate annuitization. Investors may use Section 1035 to exchange an existing contract for new one with a more favorable payout schedule.

Transfer

The final investment objective is to transfer one's wealth to intended recipients as efficiently as possible. Annuities contain survivorship benefits that accomplish that goal. All contracts will contain a minimum death benefit payable if the contractholder dies prior to annuitization. In a fixed annuity, that amount is usually the value of the initial contribution to the contract plus interest credited to the contract. (For indexed contracts, the death benefit will be based on the greater of the guaranteed minimum rate of interest or the equity-linked rate.) In the case of most variable annuity contracts, the guaranteed death benefit is the greater of the initial investment or the current value of the separate account on the date of death. This can be a comforting thought if the value of the separate account has declined since the contract's inception. Most contracts waive any surrender charges upon death. Many variable contracts today will offer enhanced death benefits — sometimes this is a pure add-on at an additional premium, sometimes the enhanced death benefit is incorporated into the standard contract by charging a higher mortality charge. Typically the enhancement will ratchet up the value of the guarantee to reflect the separate account's value on certain anniversary dates ("as of the 5th, 10th, 15th, etc. year of the contract") or the contract will provide for the guaranteed death benefit to increase by a stated percentage (e.g. 5%) per year.

As a life insurance product, death benefits payable under the annuity pass "by contract" to the designated beneficiaries, bypassing the often cumbersome probate process. In many cases, the contract may allow the holder to choose to restrict when and how the beneficiary will receive the death benefit proceeds. This is helpful in cases when the contractholder wishes to limit access to the proceeds. Usually companies will permit the contractholder to select a periodic payout method on behalf of the beneficiary or limit the amount that the insurer will release each year to the beneficiary. ***Note:*** As helpful as the guaranteed death benefits are, they generally only provide return of principal to heirs. They should not be viewed as a substitute for life insurance.

If the contract has been annuitized using a payout method other than a straight life payout, the remaining annuity payments will be paid to the beneficiary until the end of the annuity period. Again, these are paid directly to the beneficiary without the cost and delays associated with probate.

In summary, annuities can be used to meet the various investment objectives of most individuals as they age — be it accumulation of wealth in the early years of one's lifetime or the efficient distribution of those assets in later life (or upon death).

Other investment factors

During their lifetimes, most individuals will have investments objectives of accumulation, conservation, distribution and transfers. What makes each client unique, however, is the particular set of circumstances each individual faces. Advisors must apply their creative talents to adapt general investment concepts to each client's situation. The decision whether the purchase of annuity is suitable must be based on each client's unique set of circumstances. And if an annuity is purchased, the advisor should maintain contact with the client to monitor whether the annuity remains a suitable investment as the client's objectives and circumstances change.

Liquidity

Liquidity, the ability to easily turn an investment to cash without incurring large expense, is a major factor in most investment decisions. Annuities should only be purchased with "long-term money", i.e., funds that the investor can afford to invest over a long time horizon. Before making a decision to purchase an annuity, the investor should ask: "Is this money that I can afford to tie up for an extended period?" and "Do I have adequate reserves of cash or short-term investments to meet daily living expenses and unforeseen emergencies?" If the answer to either of those questions is "No", then an annuity is not a suitable investment.

Annuities can be readily converted to cash, either through withdrawals in the accumulation period or by converting the contract into a stream of income payments. There are, however, a couple of key points to keep in mind. Most contracts impose surrender charges for withdrawals in the early years of the contract. These fees are usually on a sliding scale — beginning with relatively large surrender charges in the earliest years, tapering off over the first five to seven years, and no surrender charges after that point. Surrender charges are typically waived for beneficiaries in the event the contractholder dies. For annuity issuers, marketing and underwriting costs represent a large upfront expense that must be recovered in order for the company to earn a profit. The company recoups those costs over the life of the contract. For issuers, the concept of "persistency" is critical to its profitable operations. Persistency is the average length of time a contract remains in force. Contracts that are quickly surrendered represent a losing proposition. Surrender charges are a way to recoup some of the upfront costs on contracts that are surrendered in the first few years. They also remind clients that annuities should be a long-term investment.

Another hurdle that makes annuities rather illiquid applies to deferred annuities only. The IRS essentially views deferred annuities (those with an accumulation period) as a retirement savings vehicle. As such, it grants special tax-deferred status to deferred annuities. If the client withdraws funds from the annuity prior to age 59½, the IRS will impose a 10% penalty on the withdrawal. This is similar to the penalty for premature withdrawals from tax-qualified retirement plans and IRAs. The penalty only applies to withdrawals during the accumulation period — and not to contracts that are annuitized into a stream of lifetime income payments.

Recent changes in Florida law have been motivated by agent misrepresentations of the liquid (or illiquid) nature of annuities. The suitability disclosure requirements discussed in Chapter 6 are a direct result of those misrepresentations — particularly to elderly clients.

Tax status

One of the key selling features of annuities is their tax-deferred status. Earnings in the contract grow tax-deferred, allowing the contractholder to "triple compound" his interest — interest is earned on the initial investment to the contract, on past earnings in the contract and on monies that would have been used to pay taxes on those earnings. By contrast, earnings from investment in a taxable investment, such as a mutual fund, are taxable in the year they are distributed to the investor. If the investor chooses to reinvest, only the after-tax portion of the distribution is available for compounding. Triple compounding allows for faster capital appreciation in tax-deferred contracts, and as you would expect, this is a strong incentive to invest in annuities. There are, however, tax disadvantages to an annuity too. Earnings will be taxed when the account's value is distributed to the contractholder — either as a withdrawal or as a series of periodic payments. All growth in an annuity contract's value — regardless of its source — is taxed as ordinary income, not capital gains. By contrast, profits on investments in taxable securities like mutual funds, stock or bonds, will be subject to more favorable capital gains treatment when the security is sold.

When comparing a tax-deferred annuity to other taxable alternatives, advisors should be careful to address both the tax advantages and disadvantages of the annuity. Whether the annuity makes more sense from a tax perspective depends on the investor's current tax bracket, the investor's projected tax bracket when monies will be taken out, the different treatment of ordinary income and capital gains, and the expected timeframe of the investment (the time earnings will grow tax-deferred). Obviously future changes in the tax code may also affect whether the annuity turns out to be the better investment.

In some cases, an investor will wish to purchase an annuity within a qualified retirement plan or Individual Retirement Account. As mentioned in Chapter 2, tax-deferred annuities are taxed similarly to these plans: tax-deferred growth, distributions taxed as ordinary income and a 10% penalty on withdrawal prior to age 59½. Some advisors find the idea of placing a tax-deferred annuity within a tax-deferred retirement account to be an unsuitable recommendation under any circumstance. The premise of this argument is that the beneficial tax status of the annuity is "wasted" when it is placed in a tax-deferred retirement account. By that same logic, investors should never purchase stocks or mutual funds in their IRAs — as the favorable capital gains treatment afforded these investments is "wasted", since the eventual distribution of the gain from the IRA will be taxed as ordinary income. Few advisors would make that argument. The tax status of the investment outside a qualified retirement plan should not be a reason to disqualify including that investment in the plan. (The converse, however, may be true — it often makes sense to place less tax-advantaged investments into a retirement account.) There may be many reasons to not purchase a deferred annuity within a retirement account, but this "wasted" tax benefit argument is not one of them.

Time horizon / Age

The earlier discussion about individual investment objective was based, in part, on the natural aging process. As investors grow older, there is less time to recoup losses, which leads to a natural progression from asset accumulation to wealth conservation. Advisors must pay careful attention to their client's investment time horizon. Quite often that is based on age, but sometimes the time horizon is determined by other factors. Parents saving for their children's college education may be concerned with distributions from their investments at a time in their lives when asset accumulation would seem to be an important goal. Likewise for other needs — saving for a down payment on a house or vacation property, the projected buy-out of a retiring partner's business interest, etc. While age is certainly an important factor in many investment decisions, advisors should inquire as to the purpose of the investment prior to making a recommendation.

As we've mentioned earlier, there have been numerous complaints about sales of annuities to elderly clients. Placing a client into an investment with substantial surrender charges that may remain in force for most of the client's remaining life expectancy is viewed very dimly by state insurance regulators. As we'll see in Chapter 6, Florida imposes a suitability disclosure requirement when annuities are recommended to anyone age 65 of older — and FINRA imposes disclosure requirements on the sale of variable annuity contracts to clients of any age.

Risk aversion

Some clients are inveterate gamblers; others are Chicken Littles who see the sky falling with each downturn in the market. Advisors should take the time to understand the client's tolerance to risk. Long-term (and profitable) relationships are built on mutual understanding. Advisors should determine whether their clients can sleep at night with the investment decisions they have made, and clients should be aware of the imprecise nature of investment analysis in a world of imperfect information.

All investments carry a degree of risk; some more pronounced than others. In some respects, each investment's risk is unique to that investment. There are, however, four general risks that investors should consider when making any investment: interest rate risk, purchasing power risk, creditor risk, and market (or systemic) risk.

Interest rate risk is the risk that interest rates will rise in the future. Rising interest rates make existing fixed income securities with their older, lower rates of interest less attractive. If the older security needs to be liquidated prior to maturity, the investor will suffer a loss. Even if the investor can hold until maturity, there is the ***opportunity cost*** of having locked into a lower rate than what could have been earned otherwise. Fixed annuities, with their guaranteed rate of interest are subject to this opportunity cost. Most issuers of fixed annuities will set a new rate for the contract each year — but there is no requirement that the company must match prevailing market interest rates when it resets its contractual rate. Indexed annuities will reset the rate each year based on market rates of return, but those rates are based on the returns of the stock market, which tend to be far more volatile than general interest rate fluctuations.

Purchasing power risk, or **inflation risk**, was discussed in detail above. This is the risk that the value of the dollars that are eventually returned to the investor will purchase fewer goods and services than could have been bought at the time of the original investment. Even modest rates of inflation over a long period of time can seriously erode purchasing power (e.g., 4% annual inflation over a 20-year period will cut the purchasing power of the dollar in half). While there is little the investor can do about government policies that cause inflation, he or she can minimize its effects by investing short-term, that is, don't give inflation a long opportunity to cause damage. For annuity investors, however, this is not an option as annuities (deferred annuities anyway) are inherently a long-term investment. Fixed annuities, with a fixed rate of return, are most vulnerable to the effects of inflation. Indexed annuities and variable annuities may provide some hedge against purchasing power risk.

Credit risk is the risk that the person or institution holding your money becomes insolvent and will not be able to repay investment. For the most part, life insurance and annuity companies are financially stable — and failures of large insurers are rare. Ratings organizations assess the financial strength of insurers — although in light of recent troubles on Wall Street, advisors should be aware of the shortcomings of the ratings system. State insurance regulations require companies issuing fixed annuities to maintain adequate reserves to meet their obligations, invest prudently and submit to periodic examinations to assure the public that the companies remain financially solvent. Variable annuity holders don't enjoy such protections. The sole source of protection for a variable contract is the value of the assets held by the separate account. As was noted earlier, the separate account is segregated from the firm's general assets, so in the case of insolvency, there are specific assets earmarked exclusively for the variable contractholders.

Market risk is the risk that the general stock market may experience a downturn, generally as a result of the natural progression of the economy through the business cycle. This is sometimes referred to as "systematic" risk. Studies have found the more than one-half of the change in any company's stock price is the result of general market conditions. In a bull market most stocks advance, in bear market most decline. (One can argue whether that that is a tautology, but the fact remains: when times are good, most stocks benefit, when times are bad, most stocks suffer.) Fixed annuities are immune from market risk, as their returns are based on a fixed, guaranteed rate of interest. Variable annuities are very susceptible to market risk. To a certain extent, some general market risk can be minimized by the selection of actively managed separate accounts. Some investment managers may be able to overcome general market downturns by outperforming the market. Passively managed separate accounts (and exchange traded funds, or ETFs) will be more subject to market risk, since they are designed to closely mirror the ups and downs of the general market. Indexed annuities, which links a minimum guaranteed rate of return with returns based on a measurement of the general market, are perhaps the best solution to address market risk.

One last risk, **legislative risk**, applies particularly to insurance products. Congress grants insurance and annuity products special tax treatment — primarily tax-deferred growth. That special treatment is subject to political considerations. The tax code is under constant review and revision. What Congress grants, it can take away. Investors who may invest today based on the promise of tax advantages may find those features altered in the future. Typically, Congress has "grandfathered in" old tax regulations for existing contracts when it changes the tax code, but that may not necessarily be true for any future changes Congress may make.

Creditor Protection

We live in a litigious society. High-profile clients presumed to have "deep pockets" are obvious targets for lawsuits. Some professions, such as the medicine, are more susceptible to malpractice or other legal proceedings. These types of clients may want to consider certain types of investments that offer a greater level of protection from the claims of creditors than do other assets. Sometimes the federal Bankruptcy Code provides this heightened level of protection, other times it is provided as a result of a state's laws. The most obvious examples of protected assets are the debtor's homestead, retirement plans (including IRAs), life insurance and annuities. The law offers this protection because certain assets are considered essential for the debtor and the debtor's family to maintain at least a minimum level of financial well-being and thereby avoid becoming a burden to the state. The extent of such creditor protection is, of course, tempered by society's proper concern for the creditor's competing rights to access the debtor's property for the satisfaction of legitimate claims.

The protections provided by the federal Bankruptcy Code apply nationwide — otherwise the level of protection varies widely, state by state. Florida generally offers unlimited creditor protection for proceeds of life insurance and annuity contracts. Other states may restrict the amount of that protection to amounts "reasonably necessary" for the support of the debtor and his or her dependents, some states will limit protection to a fixed dollar amount of each month's annuity payments, and still others offer no protection at all.

In Florida, creditors of an annuity contractowner may not attach or garnish the cash values or other benefits of an annuity (or insurance policy), unless the contract was obtained for the benefit of the creditor. If the annuity company releases the cash value to the contractowner, however, the creditors may bring judgment against the contractholder for the released proceeds. The same applies to death benefits paid to the estate of the contractholder. Once released to the estate, the creditors of the deceased contractholder can claim the death benefits. The protection against creditor claims is effective only as long as the annuity company holds the proceeds. . Proceeds released to a designated beneficiary (other than the estate) cannot be attached by the contractholder's creditors.

Contractholders can protect death benefits from the claims of the beneficiary's creditors by having the annuity company hold the benefits. This provision is known as the **spendthrift trust clause**. More precisely, this provision shelters proceeds that have not yet been paid to a named beneficiary from the claims of either the beneficiary's or contract owner's creditors.

The spendthrift clause does not protect to proceeds paid in one lump sum – it only applies if the proceeds may be held in trust by the insurer and paid to the beneficiary in installments over a period of time. Generally, the clause states that contract distributions payable to the beneficiary after the contractholder dies are not assignable or transferable and may not be attached in any way.

Investment Sophistication

One factor many advisors fail to consider when making recommendations is the sophistication of the investor. Basic investments, such as stocks and bonds, may be relatively easy to understand, while packaged products such as mutual funds and annuities present a more complex situation. As the famed investor Warren Buffet says: "If you can't pronounce it and can't explain it, you probably shouldn't invest in it." Some annuities, such as traditional fixed contracts, are very simple to understand: a guaranteed rate of return, fixed income payments for life with relatively few fees. On the other hand, a variable annuity's investment options, management fees, and varying values are more difficult to comprehend. The myriad moving parts of an equity indexed annuity — participation rates, spreads, caps, floors, etc. and their complex interactions — can be damned near indecipherable to the general public (and probably many financial professionals, too).

Regulatory organizations impose a number of disclosure requirements on annuity salespersons. The intent is to educate prospective clients as to the advantages and disadvantages of the annuity product and allow the client to make an informed decision. But if the client is incapable of understanding the product's features, then the product is, *per se*, an unsuitable investment for that client. If the sales pitch boils down to "trust me", the product most likely will become a future problem for both the client and the agent. In these situations, the client may trust an advisor who may not fully understand the product (after all, he was unable to adequately explain the contract to the client). This puts the client at heightened risk. For the agent, sales made in this manner are ripe for future charges of misconduct — and any short-term gain from the sales commission may be offset in the long run by much higher losses.

On the other hand, a knowledgeable salesperson who can simplify a complex investment into everyday language opens a wider range of investment opportunities to his or her clients. Just because an investment is complex or difficult to explain does not necessarily make it a bad investment. Very few people understand the detailed workings of electronic ignition switches, but this does not keep them from starting their cars in each morning. Advisors should simply be aware of the challenges of educating clients so that they understand the risks and benefits of the proposed product. In the case of complex products such as variable and indexed annuities, that educational process simply demands more time and patience from advisors — first to adequately educate themselves and then to communicate that knowledge to their clients.

That said, if a client doesn't understand what they are investing in, then the simplest and clearest path for both the client and agent is "just say no".

Estate Planning

Annuities can be useful tools for estate planning purposes. In these cases, it is not uncommon for the client to be an estate or a trust — not an individual. Ownership of annuities in these types of accounts may pose special opportunities and challenges to the financial advisor. Generally speaking, living trusts (or *inter vivos* trusts) have the same investment objectives as "regular" individual clients discussed above: accumulation, conservation, distribution and transfer. Estate clients and testamentary trusts will most likely focus on the latter two objectives: distribution and transfer.

One of the estate planning reasons for purchasing an annuity is that the annuity's benefits are available directly to the designated beneficiary in the event of the contractholder's death — that is, they are not subject to the delays and costs of the probate system. While this is true, other investments also can be structured to avoid the cumbersome probate process — joint ownership, pay on death accounts, or ownership within a retirement plan or trust. So while annuities (and life insurance policies) will bypass probate, that is not a sufficient reason, by itself, to invest in annuities as opposed to other investments.

Fixed, deferred annuities provide three useful guarantees to the estate planner: guarantee of principal, guaranteed minimum rate of return and guaranteed annuity payout factors. These guarantees provide a minimum return and minimize the client's exposure to interest rate risk. Changes in the general level of interest rates will not affect the value of the annuity — the full value of the investment is available for withdrawal (which may be subject, of course, to surrender charges). Variable deferred annuities do not offer such guarantees during the investor's lifetime — but the minimum guaranteed death benefit could provide assurance to the investor's heirs. Enhanced death benefits may provide additional comfort, locking in investment gains over the investor's lifetime or providing a minimum rate of growth in the death benefit. These can be important when the amount to be passed to heirs is a important estate-planning goal. Older clients are often wary of putting “too much” into the stock market, and the guaranteed death benefit may make the decision to invest in equities more palatable. This may allow the client to comfortably invest more heavily in stocks to provide a better returns (or a greater inheritance to heirs) than could be earned from more conservative investments.

Likewise, the creditor protection aspect of annuities may be a useful feature to the estate plan. Unlike other assets, which might be attached by the deceased's creditors, proceeds of an annuity contract are protected (to some degree) in most states. With some forethought, a person can also protect the value of the annuity from the creditors of the annuity's beneficiary.

One common goal of many estate plans is to provide periodic income to heirs — and annuities can provide an ideal way to achieve that goal. The estate plan may leave it to the estate's executor to purchase immediate annuities to fulfill that desire upon the client's death. Or a client can purchase a deferred annuity during his or her lifetime to accumulate and conserve wealth with the intention that the contract be annuitized and payable to beneficiaries after his or her death. Annuities are unique in that they are the only investment vehicles that can guarantee an income for the beneficiary's lifetime. Surviving spouses like to know that they cannot outlive their incomes, and the lifetime guarantee can comfort parents of special needs children that income will always be available for their continuing care. The greatest drawback of annuities for this purpose is that once the periodic income payments begin, they typically must continue unmodified into the future. This lack of flexibility can be a disadvantage when annuities are compared with other alternatives to provide an income for beneficiaries.

Annuities can also be used to address another estate planning dilemma: how best to invest estate assets to provide different types of benefits for different classes of beneficiaries? For example, a husband wants his estate to provide income for his surviving wife and pass remaining principal to his children by a previous marriage. (In today's society of blended families, this is becoming an increasingly common situation.) The widow will want to maximize income production; the children will want to invest for capital appreciation. How does one reconcile these two incompatible goals? A portion of the estate could be used to purchase an immediate annuity to provide an adequate income to the widow, while the balance is invested for growth. Investment setbacks in the growth-oriented assets will not affect the widow's income, nor will income payments taken from the annuity affect the children's portion. The key to this strategy's success relies how large a portion of the estate must be paid to the annuity company to provide an adequate income — and that, in turn, depends on the age of the income-receiving beneficiary (and the widow's definition of "adequate", of course). Annuities will pay a higher periodic payment to older beneficiaries than younger ones, all other factors being equal. The premium to pay an adequate income may be reasonable if the widow is older, but if she is relatively young, the premium for the annuity may be prohibitively high. Another concern may arise. Remainder beneficiaries might view the purchase of an annuity as protection from having to pay the entire estate to their stepmother if she lives a long time or if investment income can't cover annual payments — but what if she dies shortly after their father? In that case, the portion of the estate used to buy the annuity is "wasted" in the eyes of the children. A survivor benefit (e.g., 10-year period certain) would solve that perception, but that protection comes at a higher cost.

The foregoing assumes that the primary objectives of the estate-planning client are to distribute and transfer wealth after death — and as we've seen, annuities can be a direct help in that regard. But just because a client is contemplating transfer of their wealth after death does not mean that they are not concerned with their standard of living during their lifetimes. That concern can impinge on effective use of lifetime estate planning tools — such as the annual gift tax exclusion. One of the prime objections that many people have to giving substantial gifts during their lifetimes is "I might need that money". If the client and his or her spouse had a guaranteed lifetime income, that objection might be more easily overcome. The client could transfer more of the estate's value during his or her lifetime, at a lower tax and administrative cost, and perhaps with greater emotional satisfaction. Lifetime gifts also give the donor a chance to see how the gifts are used and whether the post-mortem plan needs to be modified. (Likewise, the various enhanced living benefits — GMAB, GWIB and GMWB — may assuage the investor's need for lifetime income and make a program of lifetime gifts more attractive. Whether the additional cost for these benefits is justified is a personal decision based on financial and nonfinancial considerations.)

Lastly, annuities provide a mechanism to defer taxes even after death. Taxes on the earnings within an annuity are not payable until they are distributed. Periodic annuity payments are only partially taxable — each payment is effectively part taxable income and part tax-free return of principal (the "exclusion ratio"). This is true of annuity payments to the investor during his or her lifetime as well as annuity payments made to beneficiaries after death. Meanwhile, earnings in the account continue to grow tax deferred during the annuity period. That tax deferral can be extended past death by use of a "stretch annuity". A stretch annuity is simply an annuity contract that sets the beneficiary designation such that eventual payments must be paid out to beneficiaries in the form of periodic annuity payments (not lump sum withdrawals). This can result in continued tax deferral of earnings in the account long after the investor's death. In the case of spousal beneficiaries, the surviving spouse can "step into the shoes" of the deceased investor. In turn, the spouse can name new beneficiaries, which will extend tax deferral period even longer. As noted earlier, this use of the beneficiary designation can also act as a "spendthrift clause" to protect the beneficiary from this or her creditors' claims. In a way, the annuity operates like a trust, limiting access to the underlying assets (although trusts, by their nature, can be far more flexible if that is an important estate planning goal). Some issuers offer appropriate language in their beneficiary designations to take advantage of the stretch concept, others do not.

Now let's turn our attention to various annuity prospects other than individual purchasers.

Trusts

Annuities held within a trust, or annuity distributions paid into a trust, can be problematic. Advisors should be aware of the adverse consequences when mixing annuities and trusts. The tax consequences of purchasing an annuity in a trust account were discussed in great detail in Chapter 2. Advisors should resist the urge to put annuities within a trust out of the simple belief that "everything should be held in the trust" to aid estate management and disposition.

Often, a contractholder will want to name his or her trust as the beneficiary of the annuity. In these cases, the annuity must be distributed under the "five-year rule" discussed in Chapter 2. By contrast, an annuity payable directly to a beneficiary (outside of a trust arrangement) can be paid out over the beneficiary's lifetime — which provides additional tax-deferral under the "stretch annuity" principle noted above. Presumably, distributions payable to a trust serve some other estate planning goal such as estate liquidity or greater control over the ultimate distribution to beneficiaries. In the absence of other valid planning reasons, the investor's estate plan may be better served by designating the ultimate beneficiary, rather than a trust, to receive the annuity proceeds.

Problems also arise when annuities are owned by a trust. In these cases, the owner of the trust cannot be the "measuring life" as the trust itself has an indefinite lifespan. This means that all trust-owned annuities must be "annuitant-driven" (a measuring life other than the owner's dictates when annuity payments begin). There are important distinctions between "annuitant-driven" and "owner-driven" annuities — and annuitant-driven annuities are more susceptible to unintended consequences and adverse tax treatment.

Remember that trusts that simply act as an agent of a "natural person" enjoy tax-deferred growth. Most living trusts fit that description. If, however, a trust has other purposes, it is not eligible for tax deferral of earnings. These trusts must pay tax annually on the earnings within an annuity contract.

The tax treatment of annuities and trusts was discussed in detail in Chapter 2.

Charities

Charitable organizations represent a large market for annuities. One common estate and tax planning tool is the **charitable remainder trust** (CRT). CRTs are irrevocable trusts that provide for and maintain two sets of beneficiaries. The first set is the income beneficiaries (the investor who funds the trust and, if married, a spouse). Income beneficiaries receive a set percentage of income for their lifetime from the trust. The second set of beneficiaries is the charity(s) named by the grantor. The charity receives the principal of the trust after the income beneficiaries pass away. Because of the two types of beneficiaries, CRTs are a type of "split interest" trust.

While a CRT is an irrevocable trust, the grantor (and spouse or other person) may change the charitable beneficiaries during their lifetimes. Under certain conditions, the grantor may even serve as trustee of the CRT and maintain control of the investments inside the CRT. More often, however, the charity employs a trustee — this offers the grantor a "turnkey" mechanism to turn over that responsibility to someone else.

Congress' intention when it allowed CRTs was to enhance donations to charitable organizations. As a charitable donation, CRTs offer some powerful tax-saving advantages. The most obvious is a charitable deduction on one's tax return. The size of the deduction depends on the present value of the amount the charity can expect to receive — which is related to the current fair market value of the asset, the size of the income payout percentage selected by the grantor, the expected length of the payout period, discounted by an IRS-approved interest rate. There are limitations on the size of the income tax deduction that can be taken each year (based on factors such as the grantor's taxable income and the type of asset donated.) These limitations apply to income tax deductions only. The full value of the charitable donation will be deductible for gift and estate tax purposes.

Because the assets in the trust are destined for a charity, Charitable Remainder Trusts do not pay any capital gains taxes. For this reason, CRTs are ideal for assets like stocks or property with a low cost basis but highly appreciated value. For instance, suppose a charitably–inclined investor sells an apartment building for $1 million, with the intention of donating the proceeds to a charity. Let's assume she originally paid $100,000 for the property. Upon completion of the sale, she would owe capital gains taxes on the $900,000 difference. That tax could easily top $150,000, depending on how long she owned the property and her overall tax situation. If instead, she funded a CRT with her apartment building, she effectively sells that assets without paying any capital gains taxes. Actually, the trust sells the building without capital gains taxes. As a result, the full, pre-tax value of any assets is transferred to the trust (which will provide a lifetime income to the grantor and the trust’s principal ultimately goes to the named charity).

The amount of income to come out of the CRT depends upon the payout percentage the grantor chooses, and the amount of income the assets generate while inside the CRT. The IRS states that, at a very minimum, the CRT must distribute at least 5% of the net fair market value of its assets. The payout percentage chosen by the grantor will affect the size of a charitable income tax deduction the grantor may take: the higher the payout percentage, the lower the charitable tax deduction. Another consideration, setting too high of a payout percentage may reduce the principal inside the trust too quickly. Payouts in excess of 10% each year can be problematic.

For clients concerned with leaving assets to their children, a portion of the income payments can be used to purchase a life insurance policy, payable to the children or others, to replace the value of the assets placed in the CRT — this is typically done through a separate "wealth replacement trust".

CRTs come in two flavors: "charitable remainder annuity trust" (CRAT) and "charitable remainder unitrust" (CRUT). The distinction is how the payout percentage is applied each year to determine the amount of the income payment for the grantor. **Charitable remainder annuity trusts** are set up to provide a fixed amount each year. Using the above example, the grantor transfers a $1 million investment into a CRAT with a 5% annual payout. The CRAT will pay 5% of the initial contribution, or $50,000 per year to the grantor. In the case of a **charitable remainder unitrust**, the grantor will be paid 5% based on the current value of the trust. The first annual payment will be $50,000, and future payments will be based on the value of the trust, recalculated each year. Suppose in year 2 the trust's value has increased to $1,100,000 — the second annual payment will be $55,000 (5% of $1,100,000). Since CRATs pay out a fixed dollar amount each year, fixed annuities are an ideal funding mechanism. For those wanting to participate in future growth, the CRUT is more appropriate and variable annuities can be an appropriate vehicle to deliver those varying income payments. [Some CRUTs include a makeup provision to essentially hold "excess" income for future distribution, these are sometimes called NIMCRUTs (Net Income with Makeup CRUTs) — and these can be designed with a "spigot" feature to allow the grantor to turn on or off distribution of the excess.] There are a couple of other differences between the two types of CRTs. CRATs do not permit additional contributions to the trust, CRUTs do allow for additions to the trust corpus. CRUTs must incur the cost of an annual reevaluation of the trust assets; CRATs do not.

Needless to say, setting up a CRT (of either type) is a complex transaction governed by many detailed tax regulations. For clients who would like to convert a highly-appreciated, illiquid or low-yielding assets into a stream of income, CRTs may be an appropriate solution. CRTs may also help the grantor to diversify his or her holdings. Advisors should be very careful when setting up CRTs to use experienced and knowledgeable experts to draft the proper documents and obtain tax advice. CRTs are also subject to extensive accounting requirements. As noted earlier, many charities have financial departments to assist in the process of setting up and managing CRTs.

A very informative website for those interested in more details of CRTs can be found at:
http://www.pgdc.com/pgdc/charitable-remainder-trust.

Corporations

Corporations (or other business entities) may find annuities to be helpful in meeting their obligations. The most common corporate use of annuities is to fund and distribute pension payments to their retirees. This was the initial reason issuers developed group annuities. Prior to the development of modern group annuities in the early 20th century, pension plans were a pay-as-you-go pension scheme, which primarily benefited corporate executives. Corporations would simply pay benefits to retired executives out of current earnings. Group annuities allowed corporations, in exchange for premium payments, to shift that responsibility as well as the investment and mortality risk to insurance companies. This also allowed for the expansion of retirement benefits to more rank-and-file employees — either paid fully by the employer, or through employee contributions. These group annuities provided a fixed retirement benefit usually based on the number of years of service.

Qualified Plans

When federal pension laws were reorganized under the Employee Retirement Income Security Act (ERISA) in 1974, the traditional pension plans were reclassified as defined benefit plans. As the label suggests, the benefit is "defined" (i.e., fixed by some sort of formula). ERISA mandates that defined benefit plans purchase insurance coverage from the Pension Benefit Guaranty Board (the cost of which has increased over the years). ERISA also imposed greater accounting and funding requirements on defined benefit plans to assure that companies would have adequate funds available to meet its obligations to its retirees. Plans that purchase an annuity to guarantee funding are exempted from many of the additional costs of these new regulations. As a result, ERISA motivated many defined benefit plans to become "annuity purchase plans", creating a large market for group annuities. In these traditional annuity purchase plans, the group annuity serves as a vehicle to accumulate pension funds during the employee's working years, and eventually as a distribution vehicle to pay the defined benefits.

As life expectancies lengthened, the legacy costs promised to retirees increased. In the last decades of the 20th century, many companies shifted from defined benefit plans to defined contribution plans. Instead of guaranteeing a fixed benefit to retirees, companies chose to guarantee a fixed contribution to the pension fund. The fund would eventually pay benefits that would be based on employer and employee contributions, plus investment income generated by the plan's portfolio. Initially, such plans were "money purchase" plans. Money purchase plans essentially hold a portfolio of investments for benefit of the employees as a group and are managed by the corporation as a trustee. Over time, individually tailored plans such as 401(k) plans became more popular — monies are deposited into an employee's individual account and the employee directs the fund's investments. (Tax Sheltered Annuities, discussed above, serve the same role for non-profit employers.) Regardless of the size and type of the account, all defined contribution plans shift the investment risk from the employer to the employee. Annuities, especially variable annuities with their separate accounts, are commonly used to meet the accumulation needs of the defined contribution plan. Even in those cases where the corporate trustee directly manages the investments in the plan, annuities may be an ideal vehicle for distribution of benefits to retired employees. Companies with defined benefit plans can use a portion of the investment fund to purchase an individual annuity to pay benefits for each retiree, or the company may opt for a group annuity to cover all of the company's retirees. The retirement benefits can be paid out as a guaranteed fixed annuity (subject to inflation risk), or based on the investment results of a variable annuity's separate account (subject to investment risk).

A 1982 amendment to ERISA mandates that retirement benefits paid to married workers must be paid in the form of a joint annuity, unless the worker's spouse waives that requirement in writing. This requirement, designed to protect widows and widowers from having their income cut due to the death of the covered worker, encourages the use of commercial annuities as a distribution vehicle for retirement benefits.

Separate accounts holding the investment portfolios of a variable annuity are typically registered with the SEC under the Investment Company Act. Some group variable annuity contracts are exempt from that registration requirement. Group variable annuities that are sold exclusively to qualified retirement plans need not register. This exemption applies only to plans covering at least

25 employees in which the employees make no contribution to the purchase of the annuity. Variable group annuity contracts may be issued under other conditions, but they must be registered under the Investment Company Act.

Non-Qualified Plans

While qualified retirement plans represent a large market for annuities, corporations can also use annuities to fund non-qualified retirement programs, such a deferred compensation plans. Non-qualified plans do not need to meet the broad participation standards of ERISA and can be targeted to a select group of "key" employees, instead. Non-qualified plans can be an inducement when hiring new personnel, or they can be used as "golden handcuffs" to retain employees who are critical to the company's success. In a non-qualified deferred compensation plan, the employee will forgo some of his or her current, taxable compensation in return for a promise of greater retirement benefits. The idea is to defer paying taxes on today's income and receive it in the future, presumably when the retiree is in a lower tax bracket. The employer can use the deferred compensation to purchase an annuity contract to fund and pay the promised retirement benefits.