

Annuity Products

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An annuity is simply a stream of periodic payments. Start with a lump sum of money, pay it out in equal installments over a period of time until the original fund is exhausted, and you have created an annuity. An annuity is simply a vehicle for liquidating a sum of money. Of course, in practice the concept is more complex. An important factor not mentioned above is interest. The sum of money that has not yet been paid out is earning interest, and that interest will eventually pass on to the recipient.

Individuals may purchase annuities with a single sum amount or through a series of periodic payments. The insurer credits the annuity fund with a certain rate of interest, which is not currently taxable. Over time, the value of the annuity grows. The ultimate amount that will be available for payout is a reflection of the amount the investor pays into the contract and the interest the insurance company credits to the contract.

With any annuity, there are two distinct time periods involved: the accumulation period and the payout or annuity period:

The **accumulation period** is that time during which the contractholder pays premiums into the annuity and the insurer credits interest earnings to the contract. During the accumulation period, the contractholder retains some control over the contract. For example, the contractholder may withdraw funds from the contract, surrender the contract, exchange the contract for a different type of annuity or for a contract issued by another company. The contract will detail what rights the contractholder has during this period and any limitations on those rights. In addition, the IRS may impose limitations or penalties in some circumstances. The accumulation period can last for years, or may be a momentary point in time, depending on how the contract is funded.

During the **annuity period**, the insurer pays periodic payments to the recipient. The conversion from the accumulation period to the annuity period is referred to as “annuitization”. At this point the contract turns from an investment vehicle to an income-paying device. During that process, the contractholder chooses how he or she would like the annuity payments to be paid out of the contract. Typically, benefits are paid out monthly — though a quarterly, semiannual or annual payouts are possible. There are a number of payout options the contractholder may choose. The amount of an annuity payment is dependent upon three factors: the accumulated principal, interest rate and payment period. Life insurance companies, because of their experience with mortality tables, are uniquely qualified to combine an extra factor – called the **survivorship factor** — into the standard annuity calculation. Only life insurance companies can guarantee annuity payouts lasting a lifetime.

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In some contracts there is no requirement that the contract ever be annuitized, i.e., the accumulation period may continue indefinitely. Other contracts may require annuitization by a certain date or age — this is often called the contract's starting date or maturity date. Some contracts may impose a maturity date, but allow the owner to extend the accumulation period (i.e., delay annuity payments) by giving the annuity company written notice. Regardless of the terms of the contract, once it is annuitized the contractholder loses control over the account, and the company will simply pay the income payments selected by the contractholder.

The distinction between the accumulation period and the annuity period is key to understanding contract provisions and tax treatment.

This course focuses the suitability of an agent's annuity recommendations and assumes that the student has a basic understanding of annuity contracts. If you would like a more thorough review of annuity contracts, you may access an "Annuities Primer " through the online study materials.

Please note: a more comprehensive course on annuities — which also fulfills the senior suitability requirement — is available at www.wallstreetinstructors.com. You may upgrade to the 14-credit "Annuities" course without penalty, please contact our office at 954-764-0254 or [email us](mailto:).

The rest of this chapter will explore the differences between the interest crediting methods of fixed, variable and indexed annuities, fees annuities charge and the tax consequences of an annuity investment.

Interest Credits

Fixed Annuities

Fixed annuities provide a guaranteed minimum rate of return. The contractholder's contributions into the contract are placed in the general assets of the annuity company – which invests these payments in conservative, long-term securities (typically bonds). This allows the company to credit a steady interest rate to the annuity contract. The interest payable for any given year is declared in advance by the insurer and is guaranteed to be no less than a minimum specified in the contract. So a fixed annuity has two interest rates: a minimum guaranteed rate and a current rate.

Current Interest Rate

Each annuity company credits the fixed contract with the current rate on a regular schedule, typically each year, but that rate cannot be less than the minimum guaranteed rate. Some contracts guarantee a rate of interest (higher than the minimum rate) for the first years of the contract, after which the current declared rate applies. There are four basic methods annuity companies use to apply the current interest rate to the contract:

Portfolio Method. This is the most straightforward method – all contracts are credited with the same declared rate regardless of when the contractholder paid the premium into the contract. (New contracts that have a guaranteed rate will, of course, credit interest at the guaranteed rate during the guarantee period.)

New Money Method. This method, sometimes called the "pocket of money" method, takes into account the timing of the premium payments. The company will declare an interest rate for the year and all contributions made during that year will be credited with that rate in the future. So a contract may be credited various interest rates depending on when the contractholder made contributions. For example, premiums contributed during calendar year 2007 will earn 3.65%, 2008 contributions earn 3.78%, 2009 contributions earn 3.57%, etc.

Sliding Scale Method. This method credits interest based on the size of the cash value in the annuity – larger balances earn higher rates of interest. For example, the company may declare a current rate of 4.25% for the first \$50,000 of cash value, 4.50% for the next \$50,000 and 4.60% for cash value in excess of \$100,000. Given the fixed costs of administering annuity contracts, smaller contracts are less profitable for the company, and this method takes that into account.

Tiered Interest Rate Method. This method credits different rates of interest depending on whether the contractholder eventually annuitizes the account or surrenders the contract. In these contracts, two different values are disclosed to contractholders annually – the annuity value and the cash (or contract) value. A higher rate of interest is created in the calculation of the annuity value; a lower declared rate is applied to the cash value. If the contract is eventually annuitized, the annuity payments are based on the higher annuity value. If the contract is surrendered, the contractholder receives the lower cash value. The annuity company will continue to profit from a contract that has been annuitized; that profit opportunity evaporates if the contractholder surrenders the contract – hence the company's incentive to encourage annuitization.

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Companies will declare a current rate of interest each year (or another period set forth in the contract). To a certain extent, the term "current rate" is misleading. The rate is not necessarily tied to current market conditions, nor does the company pledge to do so. "Renewal rate" is perhaps a better label. Each "renewal" rate is entirely at the discretion of the company (subject to the minimum guaranteed rate). Some companies declare very competitive renewal rates; others do not. While there is no accurate predictor of how competitive a company's future rates will be, advisors should review each company's history of interest rate renewals. Some companies in the past have offered special, introductory rates of interest — but as soon as the guarantee period ends, the contractholder find the contract pays little more than the contract's guaranteed minimum rate. There are independent sources advisors can use to ferret out the "bait-and-switch" companies, including A.M. Best (ambest.com). It is important to note that, in practice, companies rarely credit rates higher than their initial rate. The initial rates that companies offer (which are a key aspect in marketing annuities) will change as market conditions change — but once the contract is established, most companies do not base renewal rates on market conditions.

Some fixed deferred annuities offer a "**bail-out**" rate. If the renewal rate drops below the bail-out rate, the company will waive any surrender charges — this allows the contractholder to bail out of his annuity position and find other higher-yielding investments without paying a contract penalty. (Surrender charges and other contract costs are discussed below) Another variation is the so-called "CD Annuity". The type of contract guarantees its initial rate of interest during the surrender charge period (typically the first six years of the contract, or less). Designed as an alternative to bank certificates of deposit, a CD Annuity has a fixed rate of return for a number of years that is tax-deferred and no surrender charges, if held to "maturity". (For deferred annuity holders under age 59½, there may be a tax penalty for bailing out of the annuity, or if the holder of a CD Annuity is under age 59½ at "maturity".)

One popular policy feature available in some deferred annuities is the "**bonus**" interest rate. This is a rate credited over and above the current renewal rate for deposits made in the first year or first few years of the contract. The bonus interest is immediately vested with the contractholder, that is, there are no strings attached to the extra interest. Companies use the bonus to encourage additional premium contributions to the contract. While bonus interest sounds good, this incentive comes at a cost. Surrender charges on bonus contracts may be higher, interest rate guarantees may be lower or a less advantageous interest crediting method might used — as always, there are no free lunches. Some companies use the same principle to encourage annuitization (vs. surrender or withdrawals), extra interest is credited to the contract if it is annuitized.

When the contract is annuitized, a fixed annuity provides guaranteed income payments of a fixed amount based on the payout method selected by the contractholder. The contract will usually display possible payout in terms of dollars per \$1,000 of accumulated value. For example, an annuity promises a 65-year annuitant lifetime monthly payments of \$5.06 per \$1,000 of value. At age 65 the contractowner chooses to annuitize the account when the annuity had accumulated to \$100,000. The annuitant will receive \$506 per month for the rest of his life. This fixed amount is based on an interest rate that is fixed and guaranteed at the point of annuitization. As mentioned above, the contract will initially show minimum payout rates for the various payout options. In the case of deferred annuities, the company may be able to offer higher payout rates at the time of annuitization based on a higher interest rate environment at that time.

Variable Annuities

From the contract owner's point of view, the accumulation of funds in a fixed annuity is certain and the contract owner's principal is secure. The annuity company bears the investment risk. Variable annuities shift the investment risk from the insurer to the contract owner. If the investments supporting the contract perform well (as in a "bull market"), the owner will probably realize investment growth that exceeds what is possible in a fixed annuity. However, the lack of an investment guarantee means that the variable annuity owner can see the value of his or her annuity decrease in a depressed market or in an economic recession.

Separate Account

The distinguishing feature of a variable annuity is the "separate account", also called the "subaccount". The contractholder's premium contributions are credited to a separate investment account – not the annuity company's general account. Historically, separate accounts invested in securities designed to protect against inflation, primarily common stocks. Today, most annuity companies offer a variety of investment options ranging from money market funds to real estate-backed securities. (Most contracts also offer the variable contractholder a "fixed" investment alternative, which mimics the guaranteed interest rate of a fixed annuity.) Contractholders may choose to diversify their investments by directing their premiums into a variety of separate accounts and many companies offer services to periodically reallocate investments within the separate accounts to maintain desired investment balance. The contract owner may also decide to change investments from one separate account to another at little or no cost as market conditions change.

During the accumulation period, the value of the contract will vary according to the investment results in the separate account(s). When the contract is annuitized, and annuity payments begin, the size of those payments will also be based on the investment results of the separate account. This exposes the annuitant to investment risk. Variable annuity payments are subject to changing market conditions – but that was the intent of variable annuities in the first place. Annuity companies measure changing investment values using accumulation units, which pertains to the accumulation period, and annuity units, which pertains to the income payout period.

Accumulation Units

During the accumulation period of a variable annuity, contributions made by the investor are converted into accumulation units and credited to the selected separate account. Any additional contributions will purchase more accumulation units. The value of each accumulation unit varies, depending on the value of the underlying portfolio. In this way, accumulation units are similar, but not identical, to shares of a mutual fund.

The current value of one accumulation unit is found each business day by dividing the total value of the company's separate account by the total number of accumulation units outstanding. As the value of the investment portfolio rises and falls, the value of each accumulation unit also rises and falls.

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Annuity Units

When the investor decides it is time to “annuitize” the variable contract — and begins to receive monthly income payments — the accumulation units in the participant's individual account are converted into annuity units. From then on, the number of annuity units remains the same for that annuitant. The value of one annuity unit, however, can and does vary from month to month, depending on investment results.

When computing the number of annuity units, the annuity company considers the accumulated value of the account (total number of accumulation units multiplied by the current value of one accumulation unit). The company then takes into account the annuitant's age and the method of payout the annuitant selects. Using tables similar to those for a fixed annuity, the company determines the size of the initial monthly payment. Then it converts that amount into annuity units by dividing the initial monthly payment by the current value of one annuity unit.

A contractholder has purchased 10,000 accumulation units in her account by the time she is ready to retire at age 55 when the value of one accumulation unit is \$25, so the value of the account is \$250,000. She selects a joint-full survivor annuity covering her and her 65-year old husband. Based on their ages, the annuity company determines that she is entitled to \$4.08 in monthly payments for every \$1,000 of accumulated value. Her initial monthly check will be for \$1,020.00 ($\4.08×250 “thousands”). The annuity company will convert that value into annuity units. Assume that an annuity unit at that time is worth \$10. The \$1,020 payment is converted into 102 annuity units ($\$1,020$ divided by \$10). That number is fixed for the rest of their lives – it will not change. What does change is the value of the annuity units, depending on the investments in the underlying separate account. For example, if the annuity unit were to grow to \$11, her monthly check would grow too – to \$1,122 (102 units at \$11).

Each variable annuity contract will have an **assumed interest rate** (AIR). The varying value of annuity units depends on how the investment results in the separate account compare with that assumed interest rate. If the growth in the account equals the AIR, the value of an annuity unit will not change. If the investments in the separate account do better than the AIR, the value of the annuity unit will grow. If investment results lag the AIR, the value of the annuity unit will fall. Please note: the assumed interest rate in a variable contract is a threshold against which to compare investment results in the separate account – it is not a guaranteed rate of return.

Each variable annuity contract will outline the formula used to determine annuity unit values. Some contracts may rely solely on investment experience only (how the portfolio performed versus the AIR), while formulas in other contracts may reflect mortality and expense experience too.

Equity Indexed Annuities

Equity indexed annuities (EIAs) or equity indexed contracts (EICs) — relatively new entries to the annuity market — are a type of fixed annuity that offer the potential for higher credited rates of return than their traditional counterparts but also guarantee the owner's principal. The interest credited to an EIA is tied to increases in a specific equity or stock index (the most commonly used index for this purpose is the Standard & Poor's 500 Composite Stock Price Index). Underlying the contract for the duration of its term is a minimum guaranteed rate, usually 3 or 4 percent, so a certain rate of growth is guaranteed. When increases in the index produce gains that are greater than the minimum rate, that gain becomes the basis for the amount of interest that will be credited to the annuity. At the end of the contract's term — which is usually five to ten years — the annuity will be credited with the greater of the guaranteed minimum value or the indexed value.

Like a fixed annuity, the investments are held in the annuity company's general assets, not a separate account. But unlike fixed annuities, with a fixed rate of interest (minimum or the current rate the company declares periodically), the rate of interest credited to an EIC is the greater of a minimum rate or the gain on a specified index (usually the S&P 500). In other words, the rate is based on a predetermined formula, rather than the rate the annuity company chooses to pay. Another key difference is that all EICs have a stated term or duration; most other types of annuities do not.

Indexing methods

The interest rates credited to equity indexed annuities are based on changes to the underlying index. But just how are those changes measured? Each contract will spell out in (sometimes confusing) detail, how the index's performance translates into the interest rate paid on the EIC. There are several ways an equity-indexed contract may measure gains and losses in the underlying index — and these can be classified into two broad categories: the annual reset method or a point-to-point method.

In the **point-to-point method**, the contract looks at the total change between the starting value of the index and the value of the index at the end of the contract's term. Typically, the ending value of the index is divided by the starting value (minus 1) to reveal the rate of gain. For example, assume the starting value of the S&P 500 is 1,300 and the ending value is 1,690. This represents a 30% increase ($1,690 / 1,300 = 1.30$, then subtract 1.00 for an overall gain of 0.30 or 30%). The annuity's cash value will reflect that 30% increase. If the contractholder had invested \$100,000, the ending cash value will be \$130,000 (subject to various limitations discussed below). During the life of the annuity, the investor will not know what the overall rate of return will be — that rate can only be calculated at the end of the annuity's term. Also note, that variations in the index during the life of the annuity are immaterial, only the ending value is relevant to the calculation.

In contrast, the **annual reset method** takes into account annual performance. The value of the index is reviewed on each anniversary date (or other date specified in the contract). If the index's value is higher on the next anniversary, that positive return is credited to the annuity's cash value. An essential characteristic of the annual reset method is that losses in the index's value are ignored. If the index movement in any year is negative, the contract treats the return as zero and credits nothing to the cash value. For this reason, the annual reset method is sometimes called the ratchet method — changes only occur during positive periods, i.e., the cash value only "ratchets up".

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PAYMENTS FOR SPECIFIED NUMBER OF YEARS payments per \$1,000 based on interest at 3½% per year				
YEARS	ANNUAL	SEMI-ANNUAL	QUARTERLY	MONTHLY
5	213.99	107.92	54.19	18.12
10	116.18	58.59	29.42	9.83
15	83.89	42.31	21.24	7.10
20	67.98	34.28	17.22	5.75
25	58.62	29.56	14.86	4.96
30	52.53	26.43	13.30	4.45

MONTHLY LIFETIME PAYMENTS payments per \$1,000 based on interest at 3½% per year					
	LIFE ANNUITY WITH				
AGE	LIFE ANNUITY	INSTALLMENT REFUND	5 YEAR CERTAIN	10 YEAR CERTAIN	15 YEAR CERTAIN
10	3.14	3.13	3.14	3.14	3.14
20	3.26	3.25	3.26	3.26	3.25
30	3.44	3.33	3.34	3.34	3.33
40	3.73	3.69	3.73	3.72	3.70
50	4.19	4.10	4.19	4.17	4.10
60	4.98	4.75	4.96	4.90	4.66
61	5.09	4.83	5.07	5.00	4.73
62	5.20	4.92	5.18	5.10	4.79
63	5.32	5.02	5.30	5.21	4.86
64	5.46	5.12	5.42	5.33	4.93
65	5.60	5.22	5.56	5.44	4.99
66	5.74	5.33	5.70	5.57	5.06
67	5.90	5.45	5.85	5.70	5.12
68	6.07	5.57	6.02	5.84	5.18
69	6.26	5.70	6.19	5.98	5.24
70	6.45	5.84	6.37	6.13	5.30
75	7.68	6.65	7.48	6.97	5.53
80	9.43	7.71	8.98	7.87	5.67

JOINT AND FULL SURVIVOR monthly payments per \$1,000 based on interest at 3½% per year							
	OLDER AGE						
	50	55	60	65	70	75	80
50	3.70	3.77	3.82	3.86	3.89	3.91	3.93
55		3.92	4.01	4.08	4.14	4.17	4.20
60			4.22	4.34	4.43	4.50	4.54
65				4.61	4.77	4.90	4.98
70					5.16	5.38	5.54
75						5.92	6.23
80							7.00

JOINT AND ONE-HALF SURVIVOR monthly payments per \$1,000 based on interest at 3½% per year							
	OLDER AGE						
	50	55	60	65	70	75	80
50	4.22	4.29	4.60	4.85	5.14	5.47	5.83
55		4.56	4.79	5.06	5.38	5.74	6.13
60			5.02	5.32	5.68	6.09	6.52
65				5.65	6.05	6.51	7.02
70					6.52	7.05	7.65
75						7.75	8.48
80							9.52

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Since the annual reset method looks at results from year to year, gains can be credited, even if the index's current value is less than its starting value. For example, assume the index's starting value is 1,300. At the end of year 1 the index is 1,430, representing a 10% increase. A \$100,000 investment will be credited with that 10% gain; the cash value will be \$110,000 at the end of year 1. Suppose at the end of year 2, the value drops to 1,350. The negative results will be ignored, and the cash value remains at \$110,000. The bear market continues in year 3 and the index drops to 1,250. Again, this loss does not affect the cash value, which remains at \$110,000. In year 4, the index rebounds a little to 1,275. This 25-point movement represents a 2% increase over the previous anniversary value ($1,275 / 1,250 = 1.02$, minus 1.00, equals 0.02 or 2%). So cash value will increase by 2% from \$110,000 to \$112,200 ($\$110,000 \times 102\%$). Please note that the contract's cash value increases in year 4, even though the index itself is below its starting value (1,275 vs. 1,300).

There can be considerable variation in how each contract's indexing method is applied. For example, many point-to-point contracts include a **"high water mark" provision**. With this provision, the company will look at the value of the index at certain times during the contract's life, for example on each anniversary date, and the index's highest value on those dates will determine the gain to be credited to the contract. This protects investors from a significant decline in the index in the later years of the contract's life. While the overall gain will not be credited until the end of the contract's term, the gain will be based on the highest value of the index (as of the specified dates), not simply the ending value. Another way some contracts protect the annuity owner from severe declines in the index is to **average index values** over time, rather than selecting a single value at a specific point in time. For example, a contract using the annual reset method may rely on each year's average value, rather than the index value on the anniversary date. A point-to-point contract may average the index's value for the final year to measure the gain rather than the value on the ending date. Most EICs use some form of averaging. Averaging has the effect of "driving numbers to the middle" — it prevents the investor from being locked into the lowest index point of the year, but it also guarantees that the investor will never hit the highest point.

Equity Indexed Annuities versus Index Mutual Funds

At first sight, an annual reset EIC, with its ratchet affect, may appear to always outperform the index. In the bear market example above, an investment in a basket of stocks that mirror the S&P 500's weighting would have experienced a loss, from an initial value of 1,300 to 1,275 at the end of four years. By comparison, the cash value in the annual reset annuity saw an increase from \$100,000 to \$112,200. But that simple analysis overlooks some key differences. Investors in a portfolio of the S&P's stocks would receive dividends from their investments. So would investors in an indexed mutual fund or exchange traded fund such as SPDRs®. Those dividends are not factored into most EIC valuations. Put another way, the index measures only changes in the underlying stocks' prices, not the total return (capital appreciation + dividends) of an "indexed" portfolio. Cash values in annual reset annuities tend to outperform the index in periods of high market volatility, but may ignore part of the return available from an investment in the underlying stocks. Historically, dividends account for approximately 1/3 of a stock portfolio's total return. [Standard & Poor's does calculate a "total return" index related to the S&P 500, to include dividend payments — and this is commonly used to compare mutual fund or other investment performance to the general stock market. Most EICs use the "regular", i.e., no-dividend S&P 500, not the "total return 500" index. Obviously, it is important for financial advisors to know which index the contract uses.]

"Moving Parts"

Adding to the complexity of equity indexed annuities are various limitations on how the index's gains and losses are translated into changes in the contract's cash values. These limitations are referred to as the "moving parts" of the annuity. Each contract will have its own unique set of moving parts, and it is important for financial advisors to be aware of how these work, and how they interact with each other. Small variations in these provisions can significantly affect the overall return the annuity owner will actually receive.

One common limitation is a "**participation rate**". This is the percentage of change in the underlying index that is credited to the annuity. For example, a contract with a participation rate of 80% would see the contract credited with 80% of the change in the underlying index. If the index were to gain 15% in value, the contract would credit the account with an 12% gain (80% of 15%, not the full 15%); if the index went up only 7%, the contract would be credited with 5.6% (80% of 7%). Some contracts offer "full participation" meaning that 100% of the index's gain is credited to the contract. Annuity companies hedge the sale of EICs by purchasing indexed equity options — this allows them to guarantee the investment within the contract. The participation adjustment is one method annuity companies use to cover the cost of those equity options. The participation rate may be fixed for a period of time, e.g., for the first year, the first few years, or the duration of the contract; while other contracts may allow the company to change the participation rate at its discretion. Some contracts guarantee that its participation rate will never drop below a stated level; others do not. Obviously, a higher participation rate favors investors (all other factors being equal).

A variation on the participation theme is the "**yield spread**". Instead of applying a percentage reduction, a yield spread subtracts a fixed annual amount from the indexed rate of return. For example, if the annual growth in index in an annual reset contract was 10% and the contract had a 3% yield spread, the investor will be credited with only a 7% gain (10% - 3%). The spread relates to annual rates of return — so in the case of multi-year, point-to-point contracts, the overall gain in the index over the duration of the contract must be annualized before deducting the yield spread.

"**Caps**" are another way for the annuity company to limit the amount of gain credited to an EIC. Caps are simply a maximum amount that can be credited, regardless of how well the index may do in a bull market. Annuity companies use the cap in bull markets to offset the fact that index losses are ignored in bear markets. Caps may be linked to the index's results (**index cap**) or linked to the amount that will be credited to the contract (**interest rate cap**).

For example, an annual reset EIC has a participation rate of 80% and an index cap of 12%. This means that only the first 12% of any year's gain in the index will be considered in calculating the amount credited to the cash value. If the index increased by 10%, the whole index gain will be used (10% is below the index cap) — and with the 80% participation rate, the contract would be credited with an 8%. If the index gained 20% this year, only 12% (the capped amount) would be used — and that would be further reduced by the participation rate to 9.6% (80% of 12%).

In an interest rate cap, the cap relates to the amount of gain being credited to the contract. Using the same example but changing to an interest rate cap, a 20% increase in the index would be subjected to the 80% participation rate, or 16%, which exceeds the 12% cap — so the contract would credit 12% (vs. 9.6% under the index cap).

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A similar process is used if the contract uses a yield spread instead of a participation rate. If the contract had a 3% yield spread and 12% index cap, a 20% gain in the index would result in 9% credited to the account (20% gain subject to the 12% cap; 12% maximum index change less 3% yield spread = 9% actually credited). If this had been an interest rate cap instead, the investor would have been credited with 12% (20% index gain less 3% yield spread or 17%; subject to a 12% maximum under the cap).

As you can see from these examples, there is a complex interaction among a contract's moving parts. What one facet of the contract may offer to the investor can be counterbalanced by another feature. Each contract will have its own unique set of provisions. Before recommending any EIC, financial advisors should be fully aware of the details of that particular contract. Generally speaking, a contract with caps will allow the annuity company to offer higher participation rates, or lower yield spreads, as the cap limits the company's risk. There are no hard and fast rules to determine whether one contract's set of moving parts are better than another's.

For example, if a contract with a 10% index cap and 80% participation (which allows a maximum credit to the contract of 8%, [80% of 10%]) is not as good as a 9% index cap with a 90% participation rate (which allow a maximum credit of 8.1% [90% of 9%]). EICs are complex investment vehicles and, as always, the "devil is in the details".

The primary purpose of an equity indexed annuity is accumulation. Unlike other annuity contracts, an equity indexed contract has a 'maturity' date. At the end of the contract period, the accumulated value can be taken lump sum or in the form of annuity payments. In other deferred annuities, the contractholder can decide to annuitize at any time — which makes those contracts a more liquid investment than EIAs.

Death Benefits in Annuity Contracts

One commonly overlooked aspect of annuities is the guaranteed death benefit they offer. As discussed above, when the contract is annuitized (i.e., changes from the accumulation phase to the annuity phase) the contractholder may select a number of different payout options — some which provide for continuing annuity payments to a designated beneficiary.

But what happens if the annuitant dies during the accumulation phase? All annuities provide for payment of the annuity's accumulated value to a beneficiary.

In **fixed annuities**, the amount payable to the beneficiary is simply the premium payments paid into the contract plus the interest credited to the contract, less any withdrawals the contractholder may have taken. In a fixed annuity, the beneficiary simply receives the "current value" of the contract.

In **variable annuities**, the basic death benefit is the greater of the owner's investment in the contract (less any withdrawals) or the current value of the sub-account(s). The basic death benefit of a variable annuity guarantees that a beneficiary will receive, at a minimum, the monies invested in the account — and could receive far more, if the sub-account values increased.. Some variable annuity contracts offer the investor the option of purchasing enhanced death.

The death benefit feature of an **equity indexed annuity** is less clear. Some contracts will provide beneficiaries with return of the full investment plus whatever interest has been credited to the contract to date; others will return the investment plus the minimum guaranteed rate (but not the higher index rate). Each EIC is different, so it is important to read the fine print carefully.

Most annuity contracts, in the event of death, will waive any surrender charges that may apply. It is important to note that in all annuities — fixed, indexed, or variable — the minimum death benefit is designed to simply conserve the initial investment for beneficiaries. In this way annuities do afford some protection for beneficiaries, but if the goal is to maximize the amount left to beneficiaries, life insurance, not annuities, offer the greatest protection.

Remember, the guaranteed minimum death benefits are payable only if death occurs during the accumulation phase. Once the contract is annuitized, payments will continue according to the method selected by the contractholder (which may or may not include eventual payments to a beneficiary, depending on the selected payout option.)

Annuity Fees

One of the strongest arguments against the use of annuities as an investment is that they are laden with fees and other charges. While it is true that there are numerous fees associated with annuities, annuities provide a bundle of benefits not readily available through other investments and those fees represent the annuity company's compensation for providing that package of benefits. Whether a client needs all of the features of a particular annuity contract offers, and whether the fees are adequately disclosed to prospects are key questions in determining the suitability of the contract for that client. That said, few agents understand the cost structure of the annuities they sell – and perhaps because of this, they fail to adequately disclose and explain those costs. Annuity companies could certainly provide more transparency in how they structure their costs, better training for their agents and more clearly written sales materials.

Fixed Annuity Cost Factors

The simplest annuity, in terms of fees or other charges, is the fixed, single premium, immediate annuity (fixed SPIA). This represents a lump sum deposit with the annuity company, which invests those funds in the company's general assets. Periodic income payments to the annuitant begin immediately. Fixed SPIAs generally have no front-end sales charge or annual contract charges. Since these contracts are annuitized immediately, these contracts generally offer no control or flexibility to the contractholder. The annuitant can simply expect to receive his or her monthly income payment for the rest of his or her life. Some contracts, however, may permit commutation or partial withdrawals, and the annuity company will charge a fee for those distributions. The only cost component in an SPIA is built into the annuity payout factors.

Immediate Annuity Payout Factors

Each company will develop a schedule of annuity payout factors. These factors represent the monthly income payments that an annuitant will be paid if the account is annuitized. Annuity payout factors are based on the type of payout method selected by the contractholder, the current age of the income recipient, the recipient's gender, the company's assumptions on future interest rates and its projected expenses (including a profit for the company).

All contractholders who annuitize will pay an indirect profit component that is built into the annuity payout factors. Immediate annuities are immediately annuitized, so holders of immediate annuities will always pay this cost. Deferred annuity holders who elect to annuitize their contracts will also pay this cost.

The company's assumptions and projections are subject to change, so the annuity payout factors offered by companies will change over time, too. But once the contractholder decides to annuitize the current factors at that time are locked in, and that factor will be used for all future annuity payments. All future payments will be based only on that factor. In the case of immediate fixed annuities, the annuity payments will be fixed at the contract's inception. Those payments will never change, unless the contract contains a cost of living adjustment (which most do not).

Fees in Deferred Fixed Annuities

Deferred fixed annuities (whether funded by a single, lump-sum premium or flexible premiums over time) have far more complex cost structures. Historically, fixed deferred annuities imposed fewer and simpler charges than their variable cousins, but the trend is toward more complexity in both. Purchasers of fixed deferred annuities may pay any or all of the following costs (depending on the contract):

Front-end sales charge. Until recently an up-front sales charge (or "load") was commonly included in a fixed deferred contract. These are very unpopular with consumers; so few contracts today assess this charge. The load is generally stated as a percentage of the initial or subsequent premiums. In many cases it is expressed on a sliding scale — the larger the premium, the smaller the percentage.

Surrender charges. As the name implies, this charge applies if the contract is surrendered, but may also apply if the contractholder makes a substantial partial withdrawal. Most fixed deferred annuities allow withdrawals up to 10% of the contract balance each year without penalty, any excess withdrawal is subject to the charge. Each contract will spell out how the penalty is applied to excess withdrawals (is the 10% applied to each year separately or can unused withdrawals from one year be "rolled over" into future years?) but the 10% penalty-free figure is fairly standard industry wide. The surrender charge is usually expressed as in a declining schedule: for example 5% if surrender in the first year, 4% in the second year, 3% in the third year, until the surrender charge reaches zero in year 6. In the case of flexible premiums, the clock may start ticking based on contract's date or the contract may call for surrender charges on a rolling basis, with the new timeframes applied for each additional premium paid to the company. Most contracts will waive surrender charges upon the death of the annuitant (or contractholder). Likewise, many contracts will waive the charge if the owner is confined to a nursing home, becomes disabled, or suffers from a "dread disease" listed in the contract's terms.

These two charges (sales charge or surrender charge) allow the company to recover its "acquisition costs" — the cost to put the contract in force. One of those acquisition costs, but by no means the only one, is a commission paid to the salesperson. Almost all fixed annuities are sold by commissionable agents and the company must recover that cost, as well as the cost to develop the product, administrative costs, and a profit. If the contract is kept in force long enough, the company will eventually recover the acquisition costs and make a profit from various aspects of the contract. But if the contract is terminated in the early years the company loses those costs and the opportunity for profit. Hence the surrender charge (or its predecessor, the sales charge).

Contract charges. A few deferred annuity contracts assess an annual charge. If the company does impose a contract charge it will generally waive the fee when the account balance exceeds a certain amount (e.g. no contract charge if the account balance exceeds \$50,000). In effect, this is a fixed dollar fee per contract to cover administrative expenses of small, less profitable contracts.

Market Value Adjustment. Fixed annuities are typically backed by fixed-income investments such as bonds held in the company's general assets. If interest rates increase after the contract is issued, contractholders may choose to surrender the contract and to take advantage of other higher-yielding investments. Unfortunately for the company, if interest rates increase, the value of their

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fixed-income investments will decrease — and the company may have to sell investments at a loss to pay off the surrendered contracts. The market value adjustment addresses this situation. It states that if interest rates (based on some benchmark index) are higher at the time of surrender, the surrender value will be decreased; and vice versa if interest rates have declined. Generally speaking, the market value adjustment applies only on withdrawals in excess of the penalty-free amount, and only during the surrender charge period.

Interest rate spread. The interest rate spread, also called the yield spread, is typically the contract's greatest source of profit for the company. The spread represents the difference between what is promised to the contractholder and what the company can earn from its investments. This is also one of the most shadowy costs to the contractholder. The company will disclose what rate of interest it will pay on the contract, but the rate of return the company earns on its investments is not disclosed (at least not directly to the contractholder).

Equity Indexed Annuity Costs

Equity Indexed Annuities are a form of fixed annuity. What sets them apart is that the rate of return is tied to the performance of a stock index as opposed to a renewal rate set at the annuity company's discretion. Unlike variable annuities with their separate subaccounts, equity indexed contracts are backed with equity indexed stock options held in the company's general account. To cover the cost of those options, the company imposes participation rates or yield spreads. Remember that traditional fixed annuities rely on interest rate spreads — the difference between what the company promises the contractholder and the rate the company earns on its investments — to generate a profit for the company. The participation rates, yield spreads and caps perform the same function in an EIC — creating a difference between what is promised to the contractholder and what the company earns. In the case of EIC, the company earns the full return of the index; the "moving parts" of the EIC serve to reduce the return promised to contractholders, and thus generate a profit for the company. The interest rate spread was the most shadowy cost of a fixed annuity. EICs by contrast disclose the costs imposed by the moving parts openly, although it is rarely explained to prospects as a "cost". Perhaps this is because most agents are just as confused by the complexity of an EIC's interconnected "moving parts" as clients are.

Like other fixed deferred annuities, EIAs may impose many of the same charges. Most EIAs do not impose a front-end sales charge, but rely instead on surrender charges. Surrender charges are central to many complaints of EIAs and advisors must carefully consider how surrender charges affect the suitability of EIAs for each client's unique situation.

Variable Annuity Cost Factors

Variable annuities, in effect, represent an investment vehicle wrapped within an annuity contract. Variable annuity contracts have a number of costs, some relate to the subaccount's investments, others apply at the contract ("wrapper") level. The fee structure of variable annuities falls outside the scope of this course, as variable annuity sales are not covered by Florida's Senior Suitability Law. A discussion of the fee structure of variable annuities can be accessed in the "Annuities Primer" available through the online study materials.

Tax Treatment of Annuities

One feature many annuity salespersons extol is the tax-deferred nature of an annuity. While it is true that annuities offer some distinct tax advantages, it is also true that they contain tax pitfalls for the unwary. The tax code regarding annuities is very complicated and, in many instances, not entirely clear. Many factors affect the ultimate outcome of an investment in annuities: ownership, beneficiary designations, distributions requirements, etc. It is easy for an advisor to make mistakes that could have serious consequences for both the client and advisor. Therefore it is very important that financial advisors be aware of the tax regulations, if for no other reason than to be aware of the limitations of their own understanding — and refer clients to expert tax advice when conditions warrant a referral.

For a detailed discussion of tax treatment annuities is available through the online “Annuity Primer”. The following summarizes the tax treatment of non-qualified annuities held by individual taxpayers:

During the Contractholder's Lifetime:

All earnings in the account are tax-deferred. As long as the earnings remain with the annuity company, there is no tax consequence to the contractholder. (This tax-deferral is not available to all investors -- corporations, and some trusts, do not enjoy tax-deferred growth.) Taxes on that growth will be owed when the annuity company pays it out to the contractholder or beneficiary. Regardless of the source of that growth (interest in the case of fixed annuities, stock market gains in the case of variable contract), the growth portion of the contract will always be taxed as ordinary income, never as capital gains.

If the contract is annuitized, each periodic annuity payment is considered to be partial return of principal, which is tax-free, and partial return of earnings, which are taxable. The tax-free portion (or portion "excluded from tax") is based on an "exclusion ratio". For fixed annuities, that ratio compares the total investment in the contract with the total expected payments to be received by the annuitant (based on IRS life expectancy tables). For variable annuities, the annual exclusion ratio is simply the total investment in the contract divided by the annuitant's life expectancy. All taxes are the responsibility of the contractholder, regardless of who receives the periodic payments.

During the accumulation phase, the contractholder can surrender the contract, withdraw a portion of the contract's value or exchange the contract for another.

- ◆ surrender: all value in excess of the contractholder's investment (cost basis) is taxable as ordinary income
- ◆ partial withdrawal: the withdrawal may be taxable earnings or tax-free return of principal depending on how much is withdrawn and when the contract was established. For recently purchased contracts, a partial withdrawal is treated as earnings first, and then return of principal. (so-called LIFO accounting) For contract established before August 12, 1982, amounts withdrawn are treated as tax-free return of principal first, then taxable earnings (FIFO).
- ◆ exchanges: under Section 1035 of the tax code, a contractholder may exchange an annuity for another annuity free of tax consequences. (Section 1035 also permits a tax-free exchange of life insurance policy for another policy, or an exchange of a life insurance policy for an annuity contract. Section 1035 does not permit tax-free exchanges of annuities for life insurance.) There are many reasons to exchange annuity contracts: to switch from a fixed to a variable contract,

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or vice versa; to upgrade to a higher-quality annuity company; to consolidate multiple annuities into one contract; to obtain less-restrictive contract terms; to obtain a contract with more favorable annuity payout factors or contract guarantees; etc.

Upon the Contractholder's Death

If the contractholder annuitized the contract, any payments to the beneficiary must continue to be paid out at least as quickly as the annuitant was receiving (i.e., the beneficiary may not slow down the payments). The beneficiary is responsible for any income taxes owed on the payout.

If the contract was in the accumulation phase at the time of contractholder's death, the beneficiary must pay taxes on the taxable portion of the death benefits (the contractholder's cost basis in the contract is received tax-free using FIFO accounting). This is unlike life insurance death benefits, which the beneficiary receives entirely income tax free. As a general rule the beneficiary must take the accumulated value from the account no later than 5 years after the date of death. There are some exceptions to this general rule and advisors should note this is a very complicated part of the tax code.

For *estate tax purposes*, the value of the contract must be included in the decedent's estate tax calculation. If still in the accumulation period, the value of any death benefits are included in the taxable estate. If in the annuity period, the value of any remaining payments to beneficiaries must be included in the taxable estate.