ANNUITY SUITABILITY

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Annuity Suitability
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Chapter 1
Introducing Annuity Basics

History of Annuities

Not surprisingly, since uncertainty about length of life is a ubiquitous source of risk, financial contracts similar to annuities have a long history. Annuities are extraordinarily popular in modern times, but they are not new. In fact, ***annuities can actually trace their origins back to Roman times.*** Contracts during the Emperor's time were known as *annua*, or "annual stipends" in Latin. Ancient Roman contracts, known as annua, were when Roman citizens would make a one-time payment, in exchange for lifetime payments made once a year.

Annua promised an individual a stream of payments for a fixed term, or possibly for life, in return for an up-front payment. These contracts were apparently offered by speculators who usually dealt in marine and various other lines of insurance. A Roman by the name of Domitius Ulpianus, did compile the first recorded life table. The life table has the express purpose of computing the estate value of annuities that a decedent might have purchased on the lives of his or her survivors.

During the 1700s, governments in several nations, including England and Holland, sold annuities in lieu of government bonds. During this time they were used as fundraising vehicles also. The government received capital in return for a promise of lifetime payouts to the annuitants. In Europe, governments were constantly looking for revenue to pay for massive, on-going battles with neighboring countries.

During the Middle Ages, lifetime annuities purchased with a single premium became a popular method of funding the nearly constant war that characterized that period. The governments would then create a *tontine*, promising to pay for an extended period of time if citizens would purchase shares today. In return, the owner of the share received an annuity during the lifetime of their nominated person (often a child). As each nominee died, the annuity for the remaining proprietors gradually became larger and larger. This growth and division of wealth would continue until there were no nominees left.

Proprietors could assign their annuities to other parties by deed or will, or they passed on at death to the next of kin. Annuities initially were sold to all individuals at a fixed price, regardless of their age or sex. As it became clear over time that

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mortality rates for annuitants were lower than those for the population at large, a more refined pricing structure was introduced.

In the United States, annuities have been available for over two centuries. They made their first mark in America during the 18th century. In 1759, a company in Pennsylvania was formed to benefit Presbyterian ministers and their families. It was chartered as the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers. Ministers would contribute to the fund, in exchange for lifetime payments. It provided survivorship annuities for the families of ministers.

It wasn't until 1812 that Americans could buy annuities outside of a group. In Philadelphia in 1812, the Pennsylvania Company for Insurance on Lives and Granting Annuities was founded. It was the very first American company to offer annuities to the general public. It offered life insurance and annuities to the general public and was the forerunner of modern stock insurance companies.

Annuity growth from that point on was steady, but ***annuities really started to catch on in the late 1930s***. Concerns about the overall health of the financial markets prompted many individuals to purchase products from insurance companies. In the midst of the Great Depression, insurance companies were seen as stable institutions that could make the payouts that annuities promised.

During the 19th century in America, the market for annuities grew but the growth was slow. The interesting fact is that the growth for life insurance grew quickly. This disparity may, in part, reflect the different risks that these insurance products incorporate. Individuals who, if they died unexpectedly, would leave dependents in need of income support provide the traditional market for life insurance. However, on the other hand, Individuals who have no dependents or relatives to provide support if they outlive their resources provide the natural market for annuities. Extended families were common in the 19th century and thus provided an informal alternative to structured annuity contracts.

By today's standards, the first modern-day annuities were quite simple. These contracts guaranteed a return of principal, and offered a fixed rate of return from the insurance company during the accumulation period. When it was time to withdraw from the annuity, an individual could choose a fixed income for life, or payments over a set number of years. What was always proved to be attractive about annuities was their tax-deferred status. Because they were issued by insurance companies, annuities were always able to accumulate without taxes

being taken out at year-end. This allowed annuity owners to put the time value of money on their side.

The falling incidence of multi-generation households in the early 20th century contributed to the growing demand for annuity products. The Great Depression was especially significant in the history of annuities. Until then, annuities represented a miniscule share of the total insurance market. During the Great Depression, investors sought out more reliable investments in order to safeguard themselves from financial ruin.

Annuities started to grow rapidly in the late 1930s because of concerns about the overall health of the financial markets. This fact prompted many individuals to purchase products from insurance companies because the insurance companies were seen as stable institutions at the time of great depression, which could make the promised payouts.

The New Deal Program unveiled several programs that encouraged individuals to save for their own retirement. It was around this time, too, that group annuities for corporate pension plans really developed. With the economy less stable than it had ever been, many individuals looked to insurance companies as a haven of stability in what seemed a sea of anything but.

In 1952, the first variable annuity was created. Variable annuities credited interest based on the performance of separate accounts inside the annuity. Variable annuity owners could choose what type of accounts they wanted to use, and often received modest guarantees from the issuer, in exchange for greater risks they assumed. Over the years, more features were added to annuities. Some contracts provided checkbook access to funds.

Other annuities provided enhanced “bonus” rates, shorter maturity periods, and guaranteed death benefits if the owner passed away unexpectedly. What really boosted the popularity of annuities were the variable accounts. Mutual funds have mushroomed in popularity over the past two decades. In fact, there are almost twice as many mutual funds as there are stocks.

The fund managers began eyeing the growing annuity marketplace and consequently started creating separate accounts that insurance companies could use for annuity premiums. Now, to make things simple, these accounts were managed in a similar fashion to the mutual fund counterparts. The difference is

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that they were designed specifically for use in tax-deferred variable annuities. A huge portion of the annuity growth that has occurred was in variable annuities.

Defining Annuities

Before defining an annuity, it is important to know that a record number of individuals are purchasing annuities in record amounts. An annuity is a contract between an individual and an insurance company, under which the individual makes a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to this individual beginning immediately or at some future date. An annuity in its basic form is a series of payments (income) made at regular intervals over a period of time.

These periods of time are usually individuals lifetime and or spouse's lifetime. An annuity is a series of payments required to be made or received over time at regular intervals. The most common payment intervals are yearly (once a year), semi-annually (twice a year), quarterly (four times a year), and monthly (once a month).

Annuities, first and foremost, are insurance products and, secondarily, savings vehicles. That said, annuities do "make sense for someone who's already maxed out in qualified plans and is looking for a way to defer taxes on additional investments. The term *annuity* means simply a stream of payments. An annuity contract is an instrument designed to convert a sum of money into a drawn out series of payments so clients can pace their use of income over time. The buyer of an annuity hands over a lump sum or series of premiums to an insurance company, which uses actuarial tables and projected investment returns to repay the account value — plus potential appreciation — over a set period of time. Annuities account for $410 billion or 14% off the total savings amassed by families in the United States.

Annuities and Regulated Markets

Annuities are sold in regulated markets. It is vital that annuities be reasonably priced and that the annuity market be effectively regulated. Until 1850, there was little regulation of the insurance industry in the United States. Several insurance scandals led to pressure for regulation, and in 1850, New Hampshire became the first state to appoint a commissioner of insurance. Many other states followed suit in the next two decades, and in the early 1870s the insurance industry in virtually all states operated under regulatory control. The primacy of state regulation of

insurance markets was confirmed when the U.S. Congress passed the McCarran-Ferguson Act in 1945.

State insurance regulations are not uniform, and this can affect the scope of annuity products available to consumers in different places. Some industry people attribute the slow early growth of variable annuities, after their introduction by TIAA in 1952, in part to the requirement that such products receive regulatory approval in each state. Insurance regulation arose historically in part because of the complexity of insurance products and the relative lack of sophistication on the part of many insurance buyers.

Variable annuities are regulated differently than fixed annuities, with insurers maintaining separate asset pools as reserves against variable annuities. This prevents poor returns on the variable annuity portfolio from affecting the capital base for other insurance company products. Variable annuities, because of their investment component, are also regulated in part under the federal securities law.

These products are subject to provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Annuities are a unique financial product that, along with Social Security, employer pensions, your 401(k) plan, IRA and other assets, can enhance your retirement security. Discuss this option with your insurance professional or financial planner when mapping out your retirement strategy.

Options in Annuities

There are generally two types of annuities—fixed and variable. In a fixed annuity, the insurance company guarantees that you will earn a minimum rate of interest during the time that your account is growing. Annuities can also be either deferred or immediate. ***Deferred annuities are invested over an "accumulation period" of often at least 10 years, giving the premiums time to appreciate***.

At some point in the future, the account value is repaid to the client either via a lump sum, via systematic or periodic withdrawals designed to last a given period of time or via lifelong payments. If the purchaser chooses a single life annuity, income will flow for life, even after the account value is depleted. Insurers can afford to do this in the same manner as they can afford to pay life insurance to people who die young — from the pools of premiums paid by those who do not.

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Under general defining terms, there are two investing styles of annuities: fixed and variable. The fixed annuity pays a set interest rate during the accumulation phase and a predetermined amount during the annuitization period. Fixed or variable annuities are good for different reasons and for different times in one's life. Fixed annuities are good for anyone seeking an easy-to-identify stream of income down the line because they have the same basic pros and cons as bonds. They have a predictable income stream but a vulnerability to rising inflation.

It may be true that all annuities come with a price tag. So let's look at some of the fees and charges that accompany the annuity. Besides fees to the insurer and the administrator, upfront sales and back-end surrender charges often apply. The back-end surrender charges usually start as a 7% penalty for withdrawing money in the first year. But the investor must understand that they decline each year afterward.

It may be that these fees and charges make annuities less desirable to the investor than qualified retirement plans or even investments in taxable mutual funds. Most variable annuities have such high costs built into them that they are generally bad investments so an individual is generally paying 1.5% to 2.5% more in avoidable expenses. Even the annual expense ratio paid to managers of the subaccounts is higher on average than expense ratios on the same mutual fund outside an annuity.

Annuities as a Retirement Planning Tool

Annuities may be defined in many different ways but one very important on is as a retirement tool. An annuity is a retirement planning tool designed to protect against the risk of outliving one's financial resources. Annuities are one of the few financial vehicles that allow money to grow tax deferred. An annuity as a retirement-planning tool is a unique product in that it has two phases: the accumulation phase and the annuitization phase. The accumulation phase comes first, of course and the individual gives money to an insurance or investment company over a period of time or in a lump sum, and it earns a rate of return.

Second, comes the annuitization phase. In the annuitization phase, one begins to withdraw regular payments (monthly or annually) from a contract until he or she dies. Furthermore, an individual has several annuity income options, including the choice to receive either a steady stream of income throughout a lifetime or one lump sum payment if one so chooses to surrender the policy. An annuity is a fixed or variable investment contract, issued by an insurance company, that provides

income payments to an annuitant or beneficiary, beginning immediately upon issuance of the annuity (immediate annuity) or at a future date (deferred annuity).

There are many company retirement plans that are annuities paying a regular income to the retiree for his or her lifetime. Now, the original driving force behind the annuities was an income that endured for life. Because of this, the insurance companies could predict the life expectancy of a large group of people with the existing statistics. They can normally do this with a fair degree of accuracy.

What this does is enable the pricing of the annuity product accordingly. One of the differences is that with life insurance, an individual collects only if he or she dies but with a life annuity, the annuitant collects if he or she lives live. So it is the life insurance in reverse. The annuities became popular as a means of growing invested dollars tax deferred and because of the changes in regulations.

Annuities are long-term tax-deferred investments intended for retirement planning. It can be funded in a lump sum or a little at a time, and all capital in an annuity grows and compounds tax-deferred until one begins making withdrawals. Unlike retirement plans, there is no limit as to how much one can invest in his or her annuities. This is different if it is a qualified plan. There are generally no withdrawals until at least age 65 unless it's a qualified plan.

An Annuity Compared To a Life Insurance Policy

Another way that an annuity is referred to is as an "upside-down life insurance policy." With a life insurance policy, the investor pays a relatively small periodic amount in the present to get a large sum in the future. However, with an annuity, an individual normally pays a larger amount in the present. The reason for this is in order to get periodic payments over an extended period of time. It is commonly believed that a life insurance policy primarily protects dependents. The protection is against the economic harm of premature death. On the other hand an annuity is meant to protect the individual along with his or her dependents from the economic harm of outliving a life savings or other resources.

When an individual has contributed all he or she is allowed to a 401(k), IRA, or other tax-qualified retirement plan, contributing to an annuity can be a good way to supplement retirement income. It is generally believed that annuities have several advantages. Similar to tax-qualified plans, the earnings which accrue within the annuity is not subject to income tax until withdrawn. One difference is that unlike tax-qualified plans, there is no ceiling on contributions, so the investor can

contribute as much as is desired. And there is no "required beginning date," so the individual may delay the start of distributions from an annuity well into the retirement years. When ready, the individual can choose to start distributions.

An annuity is a series of payments made at regular intervals over a period of time. Annuities are issued by insurance companies. Typically, one pays in an amount of money and receives regular payments in return. State lotteries are typically paid as annuities. A 10 million dollar winner does not receive 10 million dollars upon winning. The winner receives a payout of $500,000 per year for 20 years. The state has purchased an annuity at a cost considerably less than 10 million dollars to do so.

Annuity Choices

When selecting an annuity, there will be several choices:

- **Timing of payout --** immediate or deferred: In an immediate annuity, the investor begins to receive payments immediately. This is usually for investors who need immediate income. In a deferred annuity, the investor receives payments starting at some later date, usually at retirement.
- **Investment type --** fixed or variable: Fixed annuities are invested primarily in government securities and high-grade corporate bonds. They offer a guaranteed rate over a period of one or more years, as stated on the contract. Variable annuities enable an individual to invest in a selection of sub- accounts. These sub-accounts are tied to market performance, and are often modeled after publicly-traded mutual funds.

Annuities can be:

- ***Single premium***, meaning only an initial deposit is permitted into the contract, and any additional deposits would require a new contract;
- ***Flexible premium***, which permits periodic or regularly-scheduled additions, including automatic withdrawals from a bank account. Variable annuities are almost always structured as flexible premium annuities.

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Chapter 2
Types of Annuities

To be trite, the various annuity types may have their pros and cons but flexibility, security and risk aversion continue to remain some of the most staunch advantages of annuities. Complex tax benefits are included in these advantages. These benefits can be obtained with investing in an annuity as well. The investor must realize at all times that the right choice depends on him or her and current needs and the respective portfolios.

Individual Annuities

Annuities can often be categorized within many different dimensions. Some of these dimensions include the number and timing of premiums, the number of lives covered, the nature of the payouts, and the date at which benefits begin. Most of the companies that sell annuities provide several methods of paying premiums. Some of these are options are single premium, fixed annual premium, and flexible premium annuities. Annuities have the ability to insure a single life, and also to insure multiple lives.

The payouts can begin immediately after the premium is paid with the immediate annuities. There is usually a waiting period which may involve many years (deferred annuities). The payouts may take the form of a life annuity without refund, they may offer a guaranteed minimum payout, or they may offer the annuitant a flexible structure of periodic withdrawals.

The levels of annuity contracts which are available vary greatly. On this score, the simplest individual annuity contract is a single-premium immediate annuity. With the single-premium immediate annuity, when a payment is received, the annuitant receives a guaranteed stream of future payments that begin immediately. These payments can end when the annuitant dies (a simple life annuity), when both the annuitant and a co-annuitant, such as a spouse, have died (a joint life survivorship annuity).

Group Annuities

In the financial environment that employers are currently operating in, many face major challenges in meeting the obligations of their defined benefit (DB) plans. Sustained low interest rates, are partially to blame along with a bearish stock market. The last incident is lower-than-expected earnings, all which have

combined to jeopardize adequate plan funding. The Metropolitan Life Insurance Company originally pioneered the group annuity market. This is linked to corporate defined benefit pension plans dating back to the early 1920s. The Life insurance companies were the first who began underwriting group life, health, and disability policies for large corporations in the years after World War I along with providing life annuities to retirees as a natural extension to this business.

It was in 1921 that Metropolitan began to write small contracts to manage corporate pension programs. They would collect contributions while workers were employed and then in return they would pay out benefits when the employee is retired. The group annuity market has also suffered from the same difficulties as the individual annuity market did in the early 1930s.

These difficulties were low investment returns leading to losses on group annuity contracts. These difficulties along with the passage of the Social Security Act of 1935 and the associated promise of a minimal retirement benefit for workers, led to the consequential slow growth of group annuities.

The group annuity business did continue to grow and grow rapidly in the late 1940s and continuing through the 1950s. In 1958, 3.9 million workers were covered in various types of group annuity plans and the number grew to 38 million by 1988 but declined to about 31.1 million by 1999. At one time in the history of annuities, most all group annuities were associated with defined benefit pension plans, through not all defined benefit plans were administered through group annuities. But in more recent years, group annuities have also been used in conjunction with defined contribution plans.

Mechanics of Group Annuity Products

Group annuity contracts can take on several forms. The first type that achieved popularity was the deferred group annuity contract. An employer purchasing such a contract makes periodic payments to an insurance company, which applies these payments to the purchase of deferred annuities for covered workers. The purchase price of these annuities is specified by the employer's contract with the insurance company, so the insurer indemnifies the employer against changes in rates of return, mortality risk, or other factors that could alter the pricing of deferred annuities.

Group annuity products can expand a company's portfolio of benefits and offer employees retirement savings options. One of the key attractions of deferred group annuity contracts is that employees know they have a certain pension

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income. This pension income is guaranteed by the insurance company who may be writing the annuity contract. Because some workers will not remain with the firm long enough to collect pension benefits, fully funded deferred group annuity contracts require the employer to set aside funds for future pension liabilities even though those pension liabilities may not materialize. These contracts also give the employers little flexibility in choosing the funding level for their pension.

A second type of group annuity contract is the deposit administration contract. This particular type of group annuity grew in popularity during the 1950s offering more flexibility in the timing of employer contributions and a more direct link between employer cost and the mortality or turnover experience of employees than is normal.

The insurer holds contributions to the deposit administration plan in an unallocated fund and thus promises a minimum return on this particular fund. When an employee retires, the insurer withdraws the amount which is sufficient to purchase an immediate fixed annuity. This purchase would be for the amount sufficient to purchase an immediate fixed annuity for the amount of the retiree's assured retirement benefit from the fund account.

However, the investor must understand that the insurer does not indemnify the employer against changes in the price of fixed annuities. Although the insurance company bears all risks of mortality and rate-of-return fluctuations for retired employees, the employer bears these risks for employees who have not yet reached their status of retirement.

A third class of group annuity contract, first offered in 1950 and one of the most popular in subsequent years, is the immediate participation guarantee contract. This is a variant of the deposit administration contract, with a fund account maintained by the insurer but with even more direct links between the mortality experience of covered employees, returns on investment, and the pension costs of the employer.

With an IPG plan, if the employer maintains a fund account balance large enough to fund the guaranteed annuities for all retirees, then the employer's account is credited with the actual investment experience of the insurer, and the actual payments to retirees are withdrawn from this account. In this way the employer is essentially self-insuring the mortality experience of retirees and receiving actual rather than projected investment returns.

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Classification of Annuities

Annuities are classified according to the nature of the payment and the duration of time for payment. A *fixed annuity* requires payment in a specified amount to be made for the term of the annuity regardless of economic changes due to inflation or the fluctuation of the ventures in which the principal is invested. ***A variable annuity provides for payments that fluctuate in size contingent upon the success of the investment of the principal, thus offsetting the effect of inflation upon the annuitant***. Annuities are classified according to payment by:

- Maturity date;
- How premiums are invested;
- How product is funded;
- Federal tax classification (tax treatment).

Annuities also have additional ways they are classified. An annuity is also classified by the number of lives it covers – Single or Joint & Survivorship – and by the benefit options – Immediate or Deferred. The annuity is classified by the type of premium payments – Single Premium or Flexible Premium – and by the tax treatment – Qualified or Non-Qualified.

A Straight Classification

A *straight annuity* makes variable payments at monthly or yearly intervals. A *life* or *straight life annuity* is payable to an annuitant only during the annuitant's lifetime and ceases upon his or her death. The size of the periodic payment is usually fixed based upon actuarial charts that project the expected life span of a person based upon age and physical condition, often containing provisions that promise payment to be made to a secondary beneficiary named by the annuitant.

A Refund Annuity

A *refund annuity*, or a *cash refund annuity*, promises to pay a set amount annually during the annuitant’s life. In case the annuitant dies before receiving payments for the full amount of the annuity, his or her estate will receive a sum that is the difference between the purchase price and the sum paid during the annuitant’s lifetime. This annuity guarantees that it will pay at least what the contract owner paid in premiums. If the annuitant dies before getting this amount, then the annuitant’s beneficiary will get the remainder either as cash or as installment payments.

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Joint Annuity
A *joint annuity* is one that is payable to two named persons but upon the death of one, the annuity terminates. A *joint and survivorship annuity* is a policy payable to the named annuitants during their lives and continues for the benefit of the surviving annuitant upon the death of the other.

Immediate and Deferred Classification
A Deferred Classification

A *deferred annuity* is one in which payments start at a stipulated future date only if the annuitant is alive at that time used primarily by a person who does not want to receive payments until he or she is in a lower tax bracket in retirement. A deferred annuity delays annuitization, which provides more time and opportunity for money to grow tax deferred. *An immediate annuity* provides income payments shortly after making the initial annuity payment.

Immediate Annuity

Immediate annuities can provide dependable financial security: a stream of income payments guaranteed to continue for the entirety of life or for a period specifically select. If an individual is about to retire, an immediate annuity may be a good place to put a large lump sum of money accumulated through a retirement plan or other savings vehicle. It is possible to convert the deferred annuity into an immediate annuity to start receiving income.

To purchase an immediate annuity, there is a one-time payment, and distributions must begin within a year, but typically begin within a month. Immediate annuities can be fixed or variable, just like deferred annuities. The income payments one receives from fixed immediate annuities are based on the amount he or she contribute, one's age and the interest rate environment at the time of purchase.

The payments will not change. The payments from variable immediate annuities fluctuate based on the performance of the investment options one chooses. Although payments may go up or down, variable annuities are designed to provide income that can increase over time to help an individual to keep pace with inflation. Keep in mind that because variable annuities are invested in the market, there is a possibility that one could lose money.

Contributions to an immediate annuity are not generally readily accessible. If the investor needs more income than the immediate annuity provides, he or she can

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keep some of the retirement funds in a liquid account, such as a savings account or money market fund. Also, if he or she chooses an income for life option with no refund guarantee, and should die before the contributions are all paid out, the balance of the contributions and any earnings will not go to the heirs.

Fortunately, annuities generally offer several guaranteed payout options for the heirs. When selecting the funding options for an immediate annuity, inflation is an important element. Variable annuities can let the annuitant participate in stock market growth, historically shown to be one of the best ways to combat inflation over the long term. However, the downside is that payments can drop if the market drops. Not only is this unnerving, but it will make it harder to budget. If an individual still wants the potential for higher payments, it might be plausible to consider dividing retirement savings between fixed and variable options to provide fixed payments, as well as growth potential.

Fixed Immediate Annuity

An earning's rate is locked in and monthly payments are received that include a return of investment plus taxable earnings. The amount of the monthly payment will depend on the options that one chooses and his or her age. In some cases, these are effectively used by people who want the assurance of payments that they cannot outlive.

Variable Immediate Annuity

These monthly payments will vary according to how the investments in the stock market are performing. However, there is no guaranteed monthly payment amount and it has a greater risk than a Fixed Immediate Annuity.

Deferred Annuity

If an individual wants retirement income beyond what he or she will receive from Social Security or a pension plan, a deferred annuity may be a good plan. They are particularly effective if there are many years until retirement. The money has the potential to grow, tax-deferred. That means the annuitant pays no income taxes on investment earnings until beginning to withdraw the money.

The earnings in a non-qualified annuity may accumulate on a tax-deferred basis until a withdrawal is made. The same is true with earnings in qualified accounts. These may include an IRA or 401(k) plan. At retirement, the principal and compounded earnings, if any, can be converted into a stream of payments. This

income stream may be for a fixed period, or for the greater of a fixed period or one's lifetime. The basic types of deferred annuities are:

- Variable;
- Fixed Annuities;
- Market Value Adjustment (MVA) Annuities.

Mechanics of Deferred Annuities

If the tax-deferred aspect of a deferred annuity is important, it is vital to make sure the expenses do not outweigh the tax benefits. A nonqualified deferred annuity is not a vehicle for money needed for current expenses. If an individual withdraws income before age 59½, the IRS will usually apply a 10% tax penalty. This penalty is in addition to ordinary income tax and is similar to the federal income tax penalty for early IRA withdrawals.

Besides this, the insurer may impose its own early withdrawal penalty, also known as surrender fees, if the annuitant cashes in all or part of the deferred annuity within a specified period. These fees often end after seven years of the date of purchase. ***There may be a separate surrender fee for each payment and a new payment may have a 7% fee if the investor takes out the new payment right away***.

The investor must remember that a 10-year-old payment very well may not have a surrender fee. The fee will usually decrease and be eliminated over time. An individual can often withdraw small amounts annually without any penalty from the insurer, but the federal tax penalty may still apply. In general, all taxable withdrawals are ordinary income, until all income has been paid out. Again, the prospectus for the annuity purchase will have all of the specific details pertaining to that particular annuity.

If an annuitant switches annuities, there very likely will be withdrawal charges from the current annuity. If there is a choice to change annuities despite the fact that the annuitant will be penalized, the reason has to be viable. If the annuitant decides to exchange one annuity for another, the appropriate forms must be requested from the insurance company for the transaction to be treated as a tax-free exchange under the federal income tax law.

Withdrawing Money from a Deferred Annuity

When it is time to start withdrawing money from a deferred annuity, the annuitant has a choice to make as to how he or she will receive it. Some of the choices are to take it all out in a lump sum, take it as needed, or receive it in a steady stream

of periodic payments. If the individual annuitizes, he or she can receive a stream of income that is guaranteed to continue for the rest of his or her life, no matter how long that is thus spreading the tax liability out over one's entire life.

Some of the earnings may be included in each payment and they are taxable. On the other hand tax-deferred earnings can continue to accumulate on the remaining contributions and on the earnings that have not yet been distributed. Choosing the alternative of receiving distributions as periodic payments after retirement may further reduce the income tax liability, if one is in a lower income tax bracket in later years. An individual has many options for receiving the money, each with its own tax ramifications.

The Fixed Deferred Annuity locks in a fixed rate investment approach even though guarantee periods may vary, with delayed pay-out. There is an underlying investment risk but the real risk is that the return will not beat inflation.

The Variable Deferred Annuity provides tax-deferral and potential for growth in value. This type of annuity can be suitable for those who have "maxed out" their annual contributions to other tax-deferral tools and can wait for stocks to outperform other investments over the long-term.

Variable Annuities

Variable annuities enable an individual to invest in a selection of sub- accounts, such as securities portfolios, fixed interest accounts, and money market securities. These sub-accounts are tied to market performance, and often have a corresponding managed investment portfolio after which they are modeled. An individual's money is placed in investment options known as sub accounts, which are similar to mutual funds.

Each sub account has its own degree of risk, ranging from aggressive growth funds to bond funds. The upside is that the investor has the opportunity to make substantial gains, depending on the performance of the investment. The downside is that the investor will lose money if the investments perform poorly. Another VA downside: It may cost to switch money among sub accounts. When an individual annuitizes, the payments fluctuate depending on the performance of the investments.

Some VAs allow "fixed annuitization", in which one receives fixed payments. The insurance or investment company recalculates payments each year based on the

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performance of investments. Variable annuities are better suited to investors who can withstand the volatility of the market's ups and downs and who are not dependant on the returns for necessary living expenses.

Variable annuities are essentially an insurance contract combined with an investment product. Through a professionally managed "subaccount" (similar to a mutual fund portfolio) within a variable annuity, one invests in stocks, bonds or money market funds or a combination thereof. Depending on market fluctuations, the performance of these investments will vary, hence leading to a variable return on the annuity. The insurance company does not guarantee a specified rate of return, nor does it guarantee a return of the principal. The return could potentially be higher than a fixed annuity, but the risk is higher too. In general, a variable annuity is characterized by:

- **Variable rates of return** during the accumulation (growth) phase;
- **Principal not guaranteed** by the insurance company;
- **Payments that vary** depending on the performance of the underlying investment option(s);
- **Death benefit --** Most variable annuities provide a guaranteed death benefit. This assures that the owner's heirs will receive at least the sum of all premiums paid less any withdrawals. More liberal guaranteed death benefits may be available.

An added risk protection is that variable annuity assets are held in a separate account of the insurance company. Thus, the assets are protected from the claims of the insurance company's creditors.

Variable Annuity Benefits
Variable annuities offer a number of key benefits which are explained and defined below.

Guaranteed Death Benefit -- This benefit gives the annuitant peace of mind by guaranteeing that his or her beneficiary will be protected from down markets and decreases in account value. Variable annuities can provide a death benefit for the beneficiary. What a beneficiary is eligible to receive will depend upon what stage the variable annuity has reached at that future time.

If an individual were to die without having chosen to initiate lifetime annuity payments, the beneficiary would receive a specific, guaranteed amount of money representing either the market value of the investments in the account or the

amount the investor had already put in the annuity, whichever was higher. The benefit received differs among companies and contracts, but the beneficiary is guaranteed an amount equal to what was invested or the value of the contract on the most recent policy anniversary statement, whichever is higher. This amount would be adjusted for withdrawals.

If there is an economic downturn and the overall market falls by 20% when the annuitant dies, the beneficiary will still receive the full guaranteed amount as dictated by the terms of the annuity and death benefit.

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Annuitization or Guaranteed Income Payments -- Variable annuities offer a "guaranteed income stream for life" meaning that after an agreed-upon date all designations will receive regular payments for the remainder of his or her lifetime. The payments generated from this decision to annuitize will generally be taxable in the particular year in which one receives them. This feature also offers protection against a family member outliving assets. The actual guaranteed payment does depend on the account's value at the time of annuitization. A guaranteed income for as long as the annuitant lives is what is involved here with total payments never being less than the total of the funds paid to purchase the option.

Tax-Deferred Growth -- With an investment in a variable annuity, an individual or employee typically will pay no income tax on earnings until the money is withdrawn from the account. ***Depending on the circumstances, the IRS may impose a 10% penalty tax. The reason for the 10% penalty tax is for withdrawing untaxed money from an annuity before the individual or the employee reaches age 59½.***

It is possible to use annuities in tax-qualified retirement plans, such as IRAs, pension or profit sharing plans, 401(k) plans, 403(b) plans, and 457(b) plans which are specifically for state and local government. These annuities are called "qualified annuities" and are normally funded with pre-tax dollars. On the other hand, annuities that are purchased by the public and not used in a qualified plan are called "non-qualified annuities" and are, of course, purchased with after-tax dollars.

When using a variable annuity in a qualified retirement plan, such as a 401(k) or 403(b) plan, the investor has the option to choose to make contributions on a pre-

tax basis, with all withdrawals or distribution taxed as ordinary income. Or the second option is to make contributions on an after-tax basis to the Roth 401(k) or Roth 403(b) account. In the case of the Roth account, withdrawals and distributions will not be taxed at all, as long as one has satisfied a five-year holding period and the individual is age 59½.

Variable annuities were specifically created and designed for the qualified market rather than for the non-qualified market. They have also been verified by Congress in the Internal Revenue Code to be a legitimate funding vehicle for qualified plans. When an annuity is used to fund a qualified plan, these payments from the annuity can also be used to satisfy the Internal Revenue Code's minimum distribution rules.

When considering an annuity for an IRA or other retirement plan, it is well to consider the benefits that are existing, other than tax deferral. The variable annuities do provide other benefits in comparison with other funding vehicles. An annuity used in a qualified plan can provide contract owners with most of the benefits offered by non-qualified annuities.

The benefits offered by non-qualified annuities could be guaranteed living benefits, guaranteed death benefits, and the guarantee of a maximum purchase price to turn account value into guaranteed income payments for the life of the individual or for two individuals. If these benefits are not important to the employee or other individual investing in an annuity, he or she may be better off investing in mutual funds through a qualified custodial account. Unfortunately, it does not provide any additional tax-deferred treatment of earnings.

Flexibility in Investment Options -- Variable annuities normally allow for the selection from among a variety of investment options, including different types of investment portfolios that reflect the performance of mutual funds. The investor is also able to make transfers among these different options without being subject to short-term capital gains taxes. In addition, the allocation of assets among several different asset classes may be useful in helping to produce the long-term returns, while managing one’s exposure to financial market volatility.

With non-qualified annuities, the fact that transfers can be made without a taxable event is a significant benefit. Of course, asset allocation does not assure a profit or protect against a loss. Special features which may be chosen from include:

- **Dollar Cost Averaging --** This feature can help take the guesswork out of investing by systematically buying more units of one or more selected investment options when prices are low, and fewer units when prices are high. Over time, this feature can help to hold down the unit cost of shares in a given investment.

- **Automatic Asset Rebalancing** -- This feature enables one to periodically redistribute assets among the variable annuity's investment options. This feature can help ensure that assets remain diversified and balanced.

- **Unlimited Contributions** -- Another important advantage of annuities is that they generally allow unlimited after-tax contributions, whether the individual has earned income or not, and his or her contributions can continue even after retirement. Unless one is using a Variable Annuity in a retirement plan like a 401(k), a 403(b), a 457 (b), or in a tax deferred investment vehicle such as an IRA, there is no limit to the amount of money invested in a variable annuity each year. There are no federal or state limits on the amount of after-tax income which an individual can add to a variable annuity each year. The investor must remember that an individual contract may have a ceiling.

Tax-Free Exchanges or Tax-Free Transfers

In the case that a variable annuity is not a part of a particular retirement plan or account, a tax-free exchange is referred to as a "1035 exchange." However, for a retirement plan or account, the movement of a variable annuity account to a new type of annuity account is normally referred to as a "tax-free transfer," a "trustee to trustee transfer," or, in a 403(b) account, a "Rev. Ruling 90-24 tax-free transfer." This is a description of the ability to exchange or transfer existing variable annuity for a new variable annuity contract without paying taxes. This particular right to exchange or transfer can be very useful to the investor if he or she decides that another annuity offers features or investment choices that would better meet the current needs that are presenting themselves.

Fixed Annuities

In a fixed annuity, the cash value earns a current rate of interest, which will never go below a minimum guaranteed interest rate. If one annnuitizes a fixed annuity, he or she is guaranteed a fixed payout when the annuity income begins. The upside is that there is no risk involved. The downside is that one will miss out on any gains that could have been made if the stock market performs well. When one

annuitize, the payments are also fixed. Fixed annuities are invested primarily in government securities and high-grade corporate bonds. They offer a guaranteed rate, typically over a period of one to ten years.

Fixed Immediate Annuity

The fixed immediate annuity, the simplest type, is appropriate in a variety of eldercare situations. An example could be of a 70-year-old female retiree who rolled her $250,000 IRA into a fixed immediate annuity. Under these circumstances she could receive equal monthly payments of $1,674 for the rest of her life. This could be possible with the current interest rates. A 55-year-old man taking a guaranteed income stream into retirement may convert $500,000 from his portfolio and purchase a fixed immediate annuity and thus receive a guaranteed monthly payment of $2,585, under current interest rates.

Fixed Deferred Annuity

The Fixed Deferred Annuity is similar to an immediate annuity. A fixed deferred annuity provides specific benefits. These benefits are guaranteed by the underlying insurance company that is involved. The annuity owner must understand that deferred annuity payments do not begin until value has accumulated over a period of time. An example could be of a 50-year old business owner in anticipation of retirement, might purchase a deferred annuity at face value.

This contract that he purchased will grow at a guaranteed rate and, at a specified time (whether it is age 65 or 70 or another age). In any case, it will begin to pay equal monthly payments to the business owner to supplement retirement income. The issuer guarantees the fixed rate of return in an annuity and because of this the rates of return are relatively conservative. A variable annuity may be appropriate for investors who want an aggressive approach with a longer life expectancy and/or the ability to shelter/defer income from current taxation.

Equity-Indexed Annuities

An equity-indexed annuity is a type of fixed annuity, but looks like a hybrid. It credits a minimum rate of interest, just as a fixed annuity does, but its value is also based on the performance of a specified stock index—usually computed as a fraction of that index's total return. Money is invested in a fixed account and the annuitant may earn additional interest based on the performance of a particular stock index, such as the Standard & Poor's 500 Index, the Dow Jones Industrial Average, the NASDAQ Composite Index, or the Russell 2000 Index.

With an EIA an individual gets the best of both worlds — the opportunity to earn money from stocks and the stability of a fixed account with guaranteed preservation of principal-an especially appealing factor to anyone who is averse to market losses. The only downside is that the gains one can make in the contract due to the performance of the stock index will not equal the "full" appreciation of market increase. Example: Judy may have an EIA that is paying a minimum guaranteed 8%. The S&P Index rises, increasing interest returns to 14%. Her EIA might then adjust to 12%, but not 14%.

Why is this? The 2% spread between the market and Judy's rate is the "cost" of having had the security against loss in any market drop. Another plus with the EIA is that once her interest rate is re-set, in this case to 12%, it can't go back down no matter what happens to the market.

On the flip side, if one is in an indexed annuity at 8% and the market dropped severely to a 2 or 3% level, then he or she suffers no loss on accumulated value (principal and interest) and the interest rate does not go below 8%. The guarantees in an EIA would hold the accumulated principal and earnings and this individual would suffer no market losses. EIAs offer a great deal of security for investors who wish to avoid market downside fluctuations and be assured of a minimum return. As with all annuity products, money grows tax-deferred.

Contract Features -- Two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together. The following describes some other equity-indexed annuity features that affect the index-linked formula.

Averaging -- In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

Cap Rate or Cap -- Some annuities may put an upper limit, or cap, on the index-linked interest rate. This is the maximum rate of interest the annuity will earn. In the example given above, if the contract has a 6% cap rate, 6%, and not 6.3%, would be credited. Not all annuities have a cap rate.

Floor on Equity Index-Linked Interest -- The floor is the minimum index-linked interest rate an individual will earn. ***The most common floor is 0%***. A 0% floor

assures that even if the index decreases in value, the index-linked interest that one earned will be zero and not negative.

Indexing Method -- The indexing method means the approach used to measure the amount of change, if any, in the index. Some of the most common indexing methods, which are explained more fully later on, include annual reset (ratcheting), high-water mark and point-to-point.

Margin/Spread/Administrative Fee -- In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, an annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% (10% - 2.25% = 7.75%).

Participation Rate -- The participation rate decides how much of the increase in the index will be used to calculate index-linked interest. A company may set a different participation rate for newly issued annuities as often as each day. Therefore, the initial participation rate in the annuity will depend on when it is issued by the company. The company usually guarantees the participation rate for a specific period. When that period is over, the company sets a new participation rate for the next period. Some annuities guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

Common Indexing Methods

- *Annual Reset* **--** Index-linked interest, if any, is determined each year by comparing the index value at the end of the contract year with the index value at the start of the contract year. Interest is added to the annuity each year during the term. Since the interest earned is "locked in" annually and the index value is "reset" at the end of each year, future decreases in the index will not affect the interest already earned. Therefore, an annuity using the annual reset method may credit more interest than annuities using other methods when the index fluctuates up and down often during the term.

  This design is more likely than others to give access to index-linked interest before the term ends. Interest is not credited until the end of the term. In some annuities, if an individual surrenders an annuity before the end of the term, he or she may not get index-linked interest for that term. In other annuities, one may receive index-linked interest, based on the highest anniversary value to

date and the annuity's vesting schedule. Also, contracts with this design may have a lower participation rate than annuities using other designs or may use a cap to limit the total amount of interest one might earn.

- *High-Water Mark* – When there is an index-linked interest, it is decided by looking at the index value at various points during the term, usually the annual anniversaries of the date one bought the annuity. This particular interest is based on the difference between the highest index value and the index value at the start of the term. Interest is added to the annuity at the end of the term. Since interest is calculated using the highest value of the index on a contract anniversary during the term, this design may credit higher interest than some other designs if the index reaches a high point early or in the middle of the term, then drops off at the end of the term.

- *Point-to-Point* **--** The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to an annuity at the end of the term. Since interest cannot be calculated before the end of the term, use of this design may permit a higher participation rate than annuities using other designs. Since interest is not credited until the end of the term, typically six or seven years, one may not be able to get the index-linked interest until the end of the term.

Market-Value-Adjusted Annuity

A market-value-adjusted annuity is one that combines two desirable features—the ability to select and fix the time period and interest rate over which an annuity will grow, and the flexibility to withdraw money from the annuity before the end of the time period selected. This withdrawal flexibility is achieved by adjusting the annuity’s value, up or down, to reflect the change in the interest rate “market” (that is, the general level of interest rates) from the start of the selected time period to the time of withdrawal.

Safe Investment Haven

In today’s volatile investment climate, annuities might represent a safe haven and that is exactly what retirees and near-retirees may be seeking. Annuities have some very valuable uses in retirement planning in this economic climate. In 2008, one annuity/insurance company’s total sales of income annuities topped $1.2 billion, up from $893 million the year before and also selling $ 9.35 billion in investment annuities in 2008, up from $6.18 billion for all investment annuities, including fixed and variable deferred products.

Gift Annuities

A charitable gift annuity is an irrevocable contractual arrangement made between an individual and a charitable organization. A Gift Annuity is a contract (not a "trust"), under which a charity, in return for a transfer of cash, marketable securities or other assets, agrees to pay a fixed amount of money (payment) to one or two individuals, for their lifetime, not a term of years.

It provides the donor and/or another annuitant an annual fixed income for life in exchange for the transfer of property, usually cash or marketable securities to the organization. There is no “trust” underlying the arrangement which is considered part gift and part purchase of an annuity under contract. The organization assumes the payment as a general obligation through the pledge of its entire assets and the financial risk of the investment. The age of the beneficiaries and administrative costs must be factored into the equation so that the organization ends up with at least 50% of the contributed principal as a remainder at the time of death of the last income beneficiary.

The individual who receives the annuity payments is called an "annuitant" or “beneficiary”. The fixed payments are fixed and they are also unchanged for the term of the contract. The annuity payments are not called “income”, for a portion of the payments are considered to be a partial tax-free return of the donor's gift, which are spread in equal payments over the life expectancy of the annuitants.

The contributed property or the gift, given irrevocably, becomes a part of the charity's assets, and the payments are a general obligation of the charity. The annuity is also backed by the charity's entire assets, not just by the property which has been contributed. Annuities are unlike trusts in that annuity payments continue for the life or the lives of the annuitant or annuitant, and not only as long as assets remain in the Gift Annuity Fund.

This charitable gift annuity is suited in many ways for individuals who have attained the age of 60 years, they are in reasonably good health, and who have other sources of income. The other resources must be other than what would be provided by the annuity. When the individual uses the charitable gift annuity the annuitant has the opportunity to determine the annual rate of return that he desires on the investment. Since the annuity would be purchased with "after tax dollars" a portion of the payments received from the annuity would be received as tax-free

basis. The amount of the tax-free portion, however, varies with the participant's age.

If a state does regulate charitable gift annuities, they require the charity to supply the state with a published gift annuity rate chart. This gift annuity rate chart states the maximum annuity rate that the charity offers each annuitant. These are listed by “Actuarial Age.” The Actuarial Age is the age to the nearest birthday on the gift date. Any of these regulating states, will also require the charity to publish a gift annuity rate chart for the residents of the particular state. This rate chart will also require the charity to offer the rates, shown by each actuarial age on that chart to any donor.

Types of Gift Annuities
Recognition must be giving to the different types of charitable gift annuities. Not all states permit the use of each type of Gift Annuity. Within the regulating states, the charity usually must submit a sample of each different "version" of each "type" of agreement it wishes to offer to the residents of that state before it issues that agreement.

Tuition (College) Annuity -- A Tuition Annuity (aka “College Annuity”) is a single-life deferred payment gift annuity created usually by a parent or grandparent for a young child, with the donor deferring the payments until age 18, or when the child is expected to enter college. One contemporary use of the deferred payment charitable gift annuity is as part of a tuition annuity program. As usual, the annuitant is entitled to the annuity for life; however, the annuitant has the right to sell or assign it. The child annuitant then has the option of accepting the annuity payments for his or her lifetime.

The other option is if elected before the payments start, the child can elect to receive much larger payments often referred to as the “commuted value”. This period of time can be for a term of four or five years, however it has been spelled out in the annuity agreement, at which time the payments end. Generally the option is for 4 or 5 annual payments. Some states do not permit this type of annuity, for their state law defines a gift annuity as being fixed payments made over the lifetime of the annuitant.

Deferred Charitable Gift Annuities -- ***Deferred charitable gift annuities are those in which the annuitant defers the receipt of income to a specified date at least one year in the future,*** but realizes an immediate federal income tax charitable deduction. With a Deferred Payment Gift Annuity (DPGA), the annuitant

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or annuitants start receiving payments at a future time, the date chosen by the donor, which must be more than one year after the initial date of the contribution. As with Immediate Gift Annuities, payments can be made monthly, quarterly, semi-annually or annually. Deferred charitable gift annuities are ideal for individuals who have no need for immediate income but may desire supplemental retirement income at a later date. Computations are based on the assumption that a portion of the gift principal is used to make annual payments.

Disability Annuity -- If an annuity is based on disability, there are certain work restrictions that can affect payment, depending on the amount of earnings. The annuity is not payable for any month in which the annuitant earns more than $400 in any employment or self-employment, exclusive of work-related expenses. The annuity is subject to a deduction of one month's benefit for each multiple of $400 earned over $4,800 unless withheld payments are restored if earnings for the year are less than $5,000 after deduction of disability-related work expenses. Failure to report such earnings could involve a penalty charge. These disability work restrictions cease upon a disabled employee annuitant's attainment of full retirement age, currently age 65, when the annuitant becomes subject to the work and earnings restrictions applicable to employee annuities based on age and service. This transition is effective no earlier than full retirement age even if the annuitant had 30 years of service

Flexible Annuity -- A Flexible (Deferred Payment) Gift Annuity means that the donor does NOT have to choose the payment starting date at the time of the contribution. The flexible charitable gift annuity is a simple mechanism that can increase income at a specified future date, offer both current and future tax savings, and minimize capital gains taxes. The annuitant (who may or may not be the donor) may make that choice of the payment starting date based on his/her retirement date or other considerations.

The older the annuitant(s) when the payments start, the larger the payments will be. The flexible charitable gift annuity allows the donor to defer the receipt of payments until some time in the future when he or she wishes to begin receiving them. This concept provides some of the flexibility offered by commercial annuities sold by commercial insurance companies.

The donor would choose an initial "target date" for the payments to start. The donor effectively selects a window of time during which he or she may opt for the payments to begin. The charity would then offer a range of payouts with differing fixed payment amounts and differing starting dates based on earlier or later years.

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Since the charitable deduction remains fixed, the annuity rate for each starting date would have to change. The income tax charitable deduction generated by this gift may be taken in the year the gift is made, and the resulting tax savings have the effect of reducing the cost of the gift. The payments would be lower if the starting date was earlier and higher if the starting date was later. Each annuitant would have to determine on an annual basis whether or not they wish the annuity payments to start that year.

The amount of the income tax charitable deduction is determined by the earliest date of that window. Generally, the commercially available planned giving tax calculation software does a reasonable job in explaining these various types of annuity gift vehicles and some of them will even craft the gift annuity agreement that should meet the regulatory requirements of the states involved with that particular type of annuity gift.

Railroad Employee Annuities -- The Railroad Retirement Act provides disability annuities for railroaders who become totally or occupationally disabled. Medicare coverage before age 65 is also available for totally disabled employees and also for those suffering from any type of chronic kidney disease.

The basic requirement for a regular employee annuity is 120 months or 10 years of creditable railroad service. Service months need not be consecutive, and in some cases military service may be counted as railroad service. Credit for a month of railroad service is given for every month in which an employee had some compensated service for an employer covered by the Railroad Retirement Act, even if only one day's service is performed in the month. Under certain circumstances, additional months of service may be deemed.

Covered employers include railroads engaged in interstate commerce and certain of their subsidiaries, railroad associations and national railway labor organizations. Railroad retirement benefits are based on months of service and earnings credits. Earnings are creditable up to certain annual maximums on the amount of compensation subject to railroad retirement taxes.

Since passage of the Railroad Retirement and Survivors' Improvement Act of 2001, employees with five years of service after 1995 may qualify for an annuity based on total and permanent, but not occupational, disability if they have a disability insured status under social security law. A disability insured status is established when an employee has social security or railroad retirement earnings

credits in 20 calendar quarters in a period of 40 consecutive quarters ending in or after the quarter in which the disability began.

Unlike the two-tier annuities payable to a 10-year employee, disability annuities payable to five-year employees are initially limited to a tier I social security equivalent benefit; a tier II benefit is not payable in these cases until the employee attains age 62. And, the employee's tier II benefit will be reduced for early retirement in the same manner as the tier II benefit of an employee who retired on the basis of age rather than disability at age 62 with less than 30 years of service.

Immediate Gift Annuity -- The Immediate Gift Annuity gives the annuitant payments at the end (or the beginning) of the payment period immediately following the contribution. These payments can be made monthly, quarterly, semi-annually or annually but the most common arrangement is quarterly payments made at the end of the quarter. The end of a period is not the first day of a month, but the last day of a month or period, or the anniversary date of the gift. Now it must be made clear here that the first payment is normally prorated from the date of the contribution to the end of the first period. This causes it to be smaller than the subsequent payments, but it is possible to stipulate that the first payment be for the full amount. These are the variables for the Immediate Gift Annuity product. But all of these factors must be considered because they have some effect on the amount of the charitable deduction.

The annual annuity is determined by multiplying the amount contributed measured as the fair market value on the gift date, but not the net proceeds of sale if the annuity has been funded with securities by the annuity rate.

Comparing the Types of Annuities

The annuity comparison is very important before actually deciding to make a purchase. Since there are so many annuity companies to choose from the individual really needs to compare all of the options. After all, with the annuity comparison process one may end up getting stuck with a policy that does not suit his or her needs. Among the many things that an individual should look at during an annuity comparison are, firstly, compare the details of each annuity. This includes everything from the type of annuity to the rate.

Another thing to look at during an annuity comparison is the companies that are available to make sure to buy an annuity off of an insurer that has a good reputation for being a success in the industry. In addition, make sure that the

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insurer has a customer service team that can be relied on. Overall, an annuity comparison is something that should be taken very seriously.

Qualified Vs. Nonqualified Annuities

A *qualified* annuity is one used to invest and disburse money in a tax-favored retirement plan, such as an IRA or Keogh plan or plans governed by Internal Revenue Code sections, 401(k), 403(b), or 457. Under the terms of the plan, money paid into the annuity (called "premiums" or "contributions") is not included in taxable income for the year in which it is paid in. All other tax provisions that apply to nonqualified annuities also apply to qualified annuities.

A nonqualified annuity is one purchased separately from, or "outside of," a tax-favored retirement plan. Investment earnings of all annuities, qualified and non-qualified, are tax-deferred until they are withdrawn; at that point they are treated as taxable income (regardless of whether they came from selling capital at a gain or from dividends).

Fixed vs. Variable

Annuities, in general, can be a great way to build additional capital for retirement. The focus is on the underlying investments. Fixed annuities are invested primarily in bonds, bond funds or the insurer's general account. Variable annuities are invested primarily in stocks, stock funds or stock index funds.

For now, looking at the traditional fixed annuities, the insurance company invests the premium into its general account. According to the payout option that the investor has selected, the interest gains and payment amounts are guaranteed by the insurance company. The insurance company then assumes the risk of investing the general account. With variable annuities the premiums buy units in the employee's choice of separate accounts.

At this point, it is then invested in stocks, bonds, and money market funds. The investor must understand that the annuity payout will depend on the performance of the underlying securities in the separate accounts in which the premium is invested. This is different that fixed annuities. The value of the account is not guaranteed so the employee or individual who is investing in the annuity assumes the risk involved in investing the premiums. The advantage is that in exchange he or she potentially receives higher returns.

Deferred vs. Immediate Annuities

The focus for the deferred vs. immediate annuities is on when payouts begin. Let's consider the immediate annuity first. With the immediate annuity the insurer agrees to start making payments soon after the contract is signed. On the other hand, with a deferred annuity, payments by the insurer are postponed until a later time.

A *deferred* annuity receives premiums and investment changes for payout at a later time. The payout might be a very long time; deferred annuities for retirement can remain in the deferred stage for decades.

An *immediate annuity* is designed to pay an income one time-period after the immediate annuity is bought. The time period depends on how often the income is to be paid. For example, if the income is monthly, the first payment comes one month after the immediate annuity is bought.

Single premium vs. flexible premium annuities

A *single premium* annuity is an annuity funded by a single payment. The payment might be invested for growth for a long period of time—a single premium deferred annuity—or invested for a short time, after which payout begins—a single premium immediate annuity. Single premium annuities are often funded by rollovers or from the sale of an appreciated asset.

A *flexible premium* annuity is an annuity that is intended to be funded by a series of payments. Flexible premium annuities are only deferred annuities; that is, they are designed to have a significant period of payments into the annuity plus investment growth before any money is withdrawn from them.

Fixed Period Vs. Lifetime Annuities

A *fixed period* annuity pays an income for a specified period of time, such as ten years. The amount that is paid doesn't depend on the age (or continued life) of the person who buys the annuity; the payments depend instead on the amount paid into the annuity, the length of the payout period, and (if it's a fixed annuity) an interest rate that the insurance company believes it can support for the length of the pay-out period.

A lifetime annuity provides income for the remaining life of a person (called the "annuitant"). A variation of lifetime annuities continues income until the second one of two annuitants dies. No other type of financial product can promise to do this. The amount that is paid depends on the age of the annuitant (or ages, if it's a two-life annuity), the amount paid into the annuity, and (if it's a fixed annuity)

an interest rate that the insurance company believes it can support for the length of the expected pay-out period.

With a "pure" lifetime annuity, the payments stop when the annuitant dies, even if that's a very short time after they began. Many annuity buyers are uncomfortable at this possibility, so they add a guaranteed period—essentially a fixed period annuity—to their lifetime annuity. With this combination, if one dies before the fixed period ends, the income continues to the beneficiaries until the end of that period.

More Annuity Comparisons

Equity-Indexed Annuity	*Fixed Annuity*	*Variable Annuity*	*Immediate Annuity*
Equity Indexed Annuities (EIAs) are characterized by a contract return that is the greater of an annual minimum rate (typically 3%) or the turn from a stock market index, such as the Standard & Poor's 500 index, reduced by certain expenses and formulas. If the chosen index rises sufficiently during a specific period, a greater return is credited to the contract owner's account for that period. If the stock market index does not	Fixed annuities are characterized by a minimum interest rate guaranteed by the issuing insurance company. Typically, a minimum annuity benefit is also guaranteed. With a fixed annuity, the focus is on safety of principal and stable investment returns. The fixed-rate annuity is very similar to a bank CD, but typically pays a higher minimum interest rate and offer greater security. They are	Variable annuities allow the owner to invest their annuity premium in any way they see fit. The insurance company does not share in profits of investments or protect losses. They carry the same risks as individual stocks, bonds or mutual funds. If the securities the Annuity is based on go up 20% for example, one keeps all gains, if the investments decline 20% this individual must take the loss. Variable annuities afford flexibility,	Immediate annuities are annuities designed to pay owners a determined amount of money on a monthly, quarterly, annual or semi-annual basis. The rate for an immediate annuity can be fixed-rate or variable-rate. The fixed will guarantee an individual a set income that will not fluctuate, whereas the variable option will fluctuate with performance of selected

rise sufficiently, or even declines, the lower minimum rate is credited. An owner is guaranteed to receive back at least all principal, if an EIA contract is held for a minimum period	a secure and safe, no-risk investment which makes them popular with conservative investors and for those who want to pinpoint exact returns on their investments.	allowing investors to invest simultaneously across a wide array of securities: bonds, mutual funds, stocks, futures, etc. They are designed for more aggressive investors who desire investment flexibility.	investments a variable annuity is based on. The amount received will depend on initial premium deposit, the length of time (term) of an annuity and the guarantees set forth by the particular insurer.

Chapter 3
Principles of the Annuity Contract

The Contractual Relationship

An annuity is a contract between the annuity owner and an insurance company. In return for the payment of the annuity owner, the insurance company, at that time, agrees to provide one of two things. It agrees to provide either a regular stream of income or a lump sum pay-out at some future time. This time is generally, once one retires or pass age 59½. An annuity represents a contractual relationship between the investor and an insurance company.

Although offered only by the insurance industry, annuities do not have anything to do with any type of insurance coverage. They are marketed and sold through brokerage firms, insurance agencies, banks, savings and loan institutions, financial planners, and investment advisors. The insurance company gives the contract owner certain assurances. These promises depend on the company issuing the contract, and the type of annuity chosen. There are two different types of annuities: fixed with a set rate of return, or variable in which the investor chooses from a series of portfolios that range from conservative to aggressive.

Understanding the Contract Summary

An individual must receive either a Preliminary Contract Summary or a Contract Summary prior to the time of paying the initial premium. The prospective annuitant should review the contract summary thoroughly. Accumulated values and surrender values under the contract are illustrated for various years on the summary.

During the first few years, these values may be less than premiums paid. This is why an annuity contract should not be purchased for short term purposes. Also illustrated are the yields on gross premiums at specified times. Yields take into account not only the interest credited under the contract, but also the effect of all charges.

The yield on gross premiums is a figure one can use to compare annuity contracts. It is wise to be careful in comparing this yield with yields available on other investments. The tax treatment of annuity earnings is usually substantially different from that of earnings from other investments.

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Use of the Annuity Contract

One reason many individuals buy an annuity contract is to obtain an income. Because of this an individual should review the life income figures. The values and income figures can be on both a “guaranteed” basis and on an “illustrated” basis. The “guaranteed” basis shows the minimum values and income which would be paid under the contract. On the other hand the “illustrated” basis shows the values and income which would be paid if the current interest and benefit rates were to continue in effect. It is impossible to predict future interest and benefit rates so the investor must decide whether to rely on any “illustrated” basis values when making a purchase decision or on a “guaranteed” basis.

Annuity Structure

There are four parties to an annuity--the contract owner, the annuitant, one or more beneficiaries, and the issuing insurance company that provides the annuity contract. The contract owner decides how much to invest and also names the annuitant and the beneficiaries. The annuitant (who, in many cases, is the contract owner) receives monthly payments. The annuitant’s life expectancy determines the amount of such payments.

The beneficiaries receive the contract’s value (if any) after the annuitant's death. Annuities provide various options for paying the benefits. In many cases, there are no death benefits available to beneficiaries. Thus, life expectancy clearly plays a major role in an annuity’s performance--the greater the annuitant’s life expectancy, the smaller (generally) the monthly payments. More importantly, if the annuitant dies early during the distribution phase, much of the investment could be lost. This is one of an annuity’s inherent risks. To counter this, annuities can provide optional forms of death benefits to beneficiaries in the event of the annuitant's premature death.

One example is that benefits can be paid on a joint and survivor basis. The monthly payment is payable not only for the annuitant’s life, but also for the beneficiary's. Typically, a spouse is the beneficiary; in such case, a joint and survivor annuity provides fixed payments as long as either spouse is alive. In addition to annuitized payments to a beneficiary for life, annuities can also provide either annuitized payments for a limited number of years, or a lump-sum payment to the beneficiary. This mitigates the loss resulting from an annuitant's premature

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death. For older adults, these provisions can supply necessary financial support later in life.

Parties to an Annuity Contract

When investing in an annuity, an individual enters a contract with an insurance company under which, in return for the investment, the insurer promises a stream of payments starting now or in the future. In reality, annuities are insurance contracts which are frequently used to fund structured settlements. The primary parties to an annuity include:

- **Owner** – The owner of an annuity is an entity or a person who purchases the annuity. The ownership of an annuity generally includes the rights to several things. One of the things that an annuity ownership gives is a designation or the right to change the payee and/or beneficiary. Another right is to assign the annuity or to pledge the annuity as collateral. On the other hand if the policy permits it will commute remaining payments to a lump sum. It is important for the annuity owner to understand that recent legislation authorizing factoring impacts these ownership rights in the context of a structured settlement.
- **Annuitant** – The annuitant is the "measuring" life for lifetime annuities under which payments continue for the annuitant's lifetime. Payments under some lifetime annuities ("life only") terminate when the annuitant dies. Other lifetime annuities (life and period certain) provide a certain number of payments regardless of when the annuitant dies. When an annuitant's life expectancy is reduced by injury or illness, life companies assign a "rated age" which results in either a lower cost or greater monthly benefits. Some annuities ("certain only") end at a specified date and do not include a lifetime feature.
- **Payee** – ***The payee is the person designated by the owner to receive annuity payments and may be either the annuitant or some other person or entity including a trustee or a bank account.***
- **Beneficiary** – The beneficiary is the person designated by the owner to receive any remaining payments following the death of the annuitant. Beneficiaries are also referred to as "contingent payees".

The four parties involved in the annuity contract are the insurer, the contract owner, the annuitant, and the beneficiary. The insurer is the one who is licensed to sell annuities and is the agreement between an individual and an insurance company. This person may be:

- in a local bank;
- a financial planner; or

- a brokerage firm.

The insurer will be the person investing the money. In addition to investing an individual's money, the company makes certain promises. These assurances and the term of the agreement are contained in the annuity contract. The contract spells out what can and cannot be done. Items such as additional investing, withdrawals, cancellations, penalties, and guarantees are all defined in the contract.

The Contract Owner

The contract owner is the person or the couple who invests in the annuity. A minor child can be the contract owner only if a guardian or custodian is prominently listed. Because the investor is the owner of the investment, he can gift the annuity contract to anyone or any entity at any time. A contract owner has the right to add more money, make investment decisions and changes, and withdraw all or a part of the investment, change the parties to the investment, and terminate the agreement.

The Annuitant

The annuitant, unless it is the contract owner, has no say in or control of the annuity contract. The annuitant does not have the power to make withdrawals, deposits, change the names of the parties to the agreement, or terminate the contract. Just as when an individual purchases life insurance on someone else, the annuitant must also sign the annuity contract.

The person that this individual names as the annuitant can be anyone. It can be himself or his or her spouse, parent, child, relative, friend, or neighbor. The only qualification is that the named annuitant is a person currently living who is under a certain age. The annuitant is similar to the insured in a life insurance policy. The annuitant is the individual or entity that is named on the annuity contract and the annuity will remain in force until the contract owner makes any changes or the annuitant dies.

The Beneficiary

The beneficiary is like a vice president of a country because he or she is of little value until the death of a certain individual. In the case of an annuity, the beneficiary is waiting for the death of the annuitant. And, like the beneficiary of a life insurance policy, the beneficiary of an annuity has no voice in the control or management of the policy. The only way in which the beneficiary can prosper from an annuity is upon the death of the annuitant. The named beneficiary(s) can

be children, friends, relatives, spouses, neighbors, trusts, corporations, or partnerships.

Multiple Titles

There may be four parties involved in an annuity investment, but there may not be four individuals. The same person can hold multiple titles. So one individual could be the contract owner and beneficiary or one individual could be the owner, annuitant, and beneficiary. In fact, any combination is acceptable. However, if the contract owner chooses an entity, the entity can only be the contract owner and or beneficiary, a living individual under a certain age but not a couple must be named as the annuitant. The insurer is always an insurance company, and in order to change the insurers, he or she must change insurance companies.

Payout Options

Even the premium may be a single lump sum payment or a periodic payment- and that periodic payment may be fixed or variable. Along with a variety of ways to pay for and structure the basic contract, there are a variety of payout options.

- ***Lump Sum*** -- The annuitant can receive all of the funds at once in a **lump sum** payment.
- ***Individual Life Annuity –*** This option provides regular payments for the life of the annuitant so he or she cannot outlive the income. On the other hand, payments stop when he or she dies—even if that occurs the day after receiving the first payment.
- ***A Joint And Contingent*** -- A joint and contingent provides fixed income for the annuitant's life, then to the contingent payee when the annuitant dies.
- ***Life With Cash Payment*** -- Life with cash payment provides regular payments for the life of the annuitant. However, if the annuitant dies before the total payments equal the amount paid in, the balance will go to the beneficiary. The beneficiary may receive the leftover as a lump sum or by continuing the payments as an installment refund.
- ***Interest-Only Annuities*** -- Interest-only Annuities pay the interest on the account value to the annuitant. Then at that time, the annuitant can withdraw all the funds from the account as a lump sum when he or she chooses.
- ***Life With Term Options*** -- Life with term certain provides for regular payments for the life of the annuitant. If the annuitant dies before the specified minimum number of time periods, then the beneficiary will continue to receive payments for the rest of the specified time.

- ***Joint and Survivor Options --*** Joint and survivor provisions provide income for the life of the annuitant and the specified survivor-usually a spouse. The benefit amount typically decreases after the passing of one of the annuitant.
- ***Fixed Period*** -- *Fixed period* provides payments for a specified number of periods.
- ***Systematic Withdrawal*** – ***Systematic withdrawal available under some annuity contracts, lets an individual arrange to receive designated amounts and change those amounts from time to time***. This individual cannot be sure of receiving lifetime income under this arrangement, but beneficiaries will receive any amount left in the account when the annuitant dies.
- ***The Life Annuity With Refund Option*** -- The life annuity with refund option has various provisions. For one thing it provides the annuitant with a guaranteed income for life. Then it continues the payments to the beneficiaries according to the refund provision which states that upon the death of the annuitant the beneficiaries receive an amount equal to the difference between the annuity's accumulated value prior to annuitization (payout) and the total of benefits received by the annuitant.
- ***Life Annuity With Period Certain*** -- A life annuity with period certain guarantees payments for life but pays for at least a specified number of years.
- ***Term Certain*** -- A term certain or period certain annuity makes payments for the period one elects and then stops. If he or she dies before the end of the period, the named beneficiary or beneficiaries will receive payments for the remainder of the guaranteed period.

How much an individual will receive under any annuity depends on age when distributions begin. The older one is, and therefore the shorter one's life expectancy, the more he or she will receive. But the amount also depends on the payment option selected. The largest payments are typically made under an individual life annuity—but this may not be the best choice if it will leave a surviving spouse in need of income.

Investment in the Annuity Contract

An annuity is a long term investment tool utilized through an insurance company. It allows an individual to acquire earnings that are tax-deferred until the money is withdrawn, while earning interest. While anyone can offer an annuity, only life insurance companies are able to guarantee the income over the entire life of it. An annuity is an investment product that has an insurance policy packaged with it.

The investment portion allows a spread of money among one or more funds (called sub-accounts); or, in the case of a fixed annuity, money may be invested by the insurer through its general account. There is no such thing as the perfect investment, however, an annuity provides more features than any other type of investment available, including Safety, Reserves, Financial strength, and Ratings.

Taxation on Investments in the Annuity

In figuring how much of a pension or annuity is taxable under the General Rule, one must figure the investment in the contract. An individual has to find his or her net cost of the contract as of the annuity starting date. To find this amount, one must first figure the total premiums, contributions, or other amounts paid. This includes the amounts an employer contributed if he or she were required to include these amounts in income. It also includes amounts one actually contributed. From this total cost one subtracts:

- Any refunded premiums, rebates, dividends, or unrepaid loans that was received by the later of the annuity starting date or the date on which the first payment was received;
- Any additional premiums paid for double indemnity or disability benefits;
- Tax-free amounts received under the contract before the later of the dates in the first bullet.

The annuity starting date is either the later of the first day of the first period for which one receives payment under the contract or the date on which the obligation under the contract becomes fixed, whichever comes later.

Transferring Investments

One does not pay any tax penalty if he transfers money among sub-accounts. However, many companies charge a fee for re-allocating one's money to different sub-accounts. Fees vary by company, but one often has to pay an administrative fee (usually about $20 to $25) for moving his money into different sub-accounts. In some cases, the first 12 transfers are free or the fees may be waived if one has a minimum amount in his investment.

A Transfer Payout Annuity

A Transfer Payout Annuity (TPA) is an annuity option that provides for transfers and withdrawals of accumulated funds in 10 annual installments, based on the payout rates in effect on the date the TPA amount is transferred or paid in cash. All investors must be aware that TPA is also a return of an interest

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earned on the sum converted from a Traditional Account in an RA or GRA. But that is not all. Interest is also earned from the return from the principal of that sum. A TPA is not an accumulating annuity like a Retirement Annuity or Group Retirement Annuity. The reason that this is important is that it will not have an accumulation value. The contract value is based on the present value of the remaining TPA installments. This value will decrease as each transfer or payment is made.

Chapter 4
Mechanics of Annuities

The Phases of an Annuity

The life of an annuity can be broken down into two phases:

- ***Accumulation* –** Any earnings on the contract accumulate tax-deferred. The payment into an annuity is called a Purchase Payment because one is buying an annuity contract. Once an individual has made the initial Purchase Payment, the annuity will have two phases. One of the two phases will be the accumulation phase where the money has the potential of growing tax deferred. The second of the two phases is the income or payout phase where an individual withdraws his or her money according to a choice of payment options. During the accumulation phase, a fixed annuity will earn a guaranteed minimum interest rate for a certain period of time.

- ***Annuitization*** – One chooses an annuity payout option and begins receiving income. This is when the annuitant receives annuity payments from the annuity account. When an insurance company begins paying out the proceeds of an annuity on a monthly basis, the annuity is said to be annuitizing. The process is called annuitization. An individual should not annuitize his annuity without careful thought. Once an annuity is annuitized, the annuitization cannot be reversed or the withdrawal of the funds within the annuity is no longer possible. Annuitization effectively exchanges the cash in the annuity for a guaranteed income stream, and as a result, it is quite inflexible. The income is distributed as the contract requires, but there is no flexibility to increase or decrease the payments or to make cash withdrawals from the principal.

All annuity contracts will consistently have an accumulation phase and an also an income phase. During the accumulation phase, an investment is held by the insurance company. Depending on the type of annuity - fixed, variable, or modified guaranteed - the money will be directed to the funding option that was selected. The earnings are tax-deferred, which means all the money, including the amount, would otherwise be paid in current income taxes, remains in the contract to generate potentially more earnings.

The individual can take withdrawals from the contract during the accumulation phase. However, as with other tax-deferred investments, taxes are paid taxes on earnings and untaxed contributions (IRA’s only) when they are withdrawn. A

federal tax penalty may apply if withdrawals are taken before age 59 ½. In addition, surrender charges and other charges under the contract may apply.

In the case that an individual decides to begin taking income payments from the annuity, it is possible to do so by annuitization or a minimum distribution program from the contract provided that. Among other factors, the amount of money that an individual is able to accumulate in the contract during the accumulation phase will affect the amount of income payments during the income phase. So let's look more close at the two distinct phases to an annuity – that of the accumulation (or investment phase), and the distribution phase.

Accumulation

The accumulation phase is the time period when money is added to the annuity. During the accumulation period, the annuity contract owner's interest in the separate account is measured by accumulation units. Accumulation units track the shares of a variable annuity in the separate account, which is invested more aggressively for greater income. The number of accumulation units in the account is proportionate to the amount of money invested.

These accumulation units are simply an accounting method of measuring the contract owner's interest in the separate account. The annuity can be purchased in one lump sum simply referred to as a single payment annuity, or a series of payments can be added in an annuity. The accumulation phase of an annuity is the time during which the value of the annuity is growing. This phase ends when the annuitization or payout phase begins. This payout phase begins the day one starts receiving payments.

Accumulation refers to buying over a period of time. This might be done by an institutional investor to avoid making a single substantial purchase that might drive up the market price, or by a retail investor who wants to reduce risk by dollar-cost averaging. The payments may be of equal size over a number of years, or they may consist of a series of variable payments.

Distribution

The distribution phase is when the policy owner begins receiving distributions from the annuity. The distribution phase starts as soon as the first withdrawals are sent out as payments to the investor. A 20-year guaranteed annuity would have a distribution phase of 20 years and would have a guaranteed payout. There are two general options for receiving distributions from the annuity.

- ***Option 1*** – ***Withdrawal Option*** – For the option 1, an individual can choose to simply withdraw earnings or even the earnings and the principal from the annuity. All the money can be withdrawn in the annuity in one lump sum or the money can be withdrawn over a period of time through regular or irregular withdrawals. By choosing to make withdrawals from the annuity, the individual continues to have control over money the invested money and could be similar to a savings account at a bank.

- ***Option 2 – Guaranteed Income Stream*** – For the option 2, the annuitant will receive a guaranteed income stream from the annuity and it will be "annuitized," which means that the current value of the annuity is converted into a stream of payments Commonly referred to as the guaranteed income option, the annuity issuer promises to pay an amount of money on a periodic basis such as monthly, quarterly, yearly.

  However, the individual has the choice to elect to receive either a fixed amount for each payment period which is often referred to as a fixed annuity payout. It can also be referred to as a variable amount for each period. The amount the individual receives for each payment period will depend on the cash value of the annuity, or in other words how earnings are credited to an account, and the age at which the annuity payments were being received. The individual can receive the income stream for an entire lifetime, or it can be received as an income stream for a specified time period which can be 10, 15, 20 years or some other number of years.

An individual has the option to elect to receive the annuity payments over a lifetime and/or the lifetime of another person. The amount received for each payment period will depend on how much money there is in the annuity, how earnings are credited to the account, and the age at which the individual begins the annuitization phase. The length of the distribution period will also affect how much is received because if a 65-year-old elects to receive annuity distributions over an entire lifetime, the amount he or she will receive with each payment will be less than if annuity distributions over five years had been elected.

Annuitization

An annuitization is a payout option other than a lump sum payment. Some payout options guarantee an income for as long as one lives, while other options spread the distribution out over the number of years that which the annuitant chooses.

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Guaranteed lifetime options include life income only, life income with a guaranteed number of payments, and joint life payments. Non-lifetime options include payments for a fixed number of years or payments of a specified amount. When the annuitant selects a settlement option, the accumulation units are converted to a fixed number of annuity units according to a formula the number of annuity units which will never change.

What varies is the value of each annuity unit, which will depend on the value of the portfolio in the separate account. When the performance of the separate account changes, the value of each annuity unit changes. At this time the payment which is calculated by multiplying the number of annuity units times the value of one to the annuitant changes. Variable annuity contracts specify how often the payout can be changed: monthly, quarterly, semi-annually, or annually.

The calculation for the first payment of a variable annuity is the same as for the fixed annuity, but the dollar amount is converted to an equivalent of annuity units. For a variable annuity, the number of annuity units is calculated by dividing the first payment by the current value of an annuity unit. This will yield a number that will not change during the annuity period; what changes is the value of the annuity unit.

Thus, the annuitant’s payment is equal to the number of annuity units times the value of each unit. So if $500 is the first payment, and $5 is the value of each annuity unit, then the annuitant has an interest in 100 units, which will not change. The value of the annuity unit, and therefore the payment to the annuitant, will rise and fall, depending on the value of the annuity unit, which in turn, will depend on the performance of the separate account.

With fixed annuitization, the investor knows the amount of money he or she will receive and for what length of time it will be receive. A steady income stream in retirement can be a great source of comfort and security, especially if one will not have a pension from an employer.

Annuitized payments may be used to pay premiums on a long-term care insurance policy, or the payments themselves may be used to meet long-term care costs. In fact, converting assets to income through annuitization may prevent disqualification for Medicaid benefits.

Taxation to the Beneficiary at the Annuitant's Death (Post-Annuitization)
In cases where an annuitant owns a term certain or refund annuity and dies after payments begin but before receiving the full amount guaranteed, the balance is paid to a designated beneficiary. The amounts paid to the beneficiary – whether as a single payment or in installments – are received tax free until the sum of all payments that were excluded from tax exceed total premiums invested. After that, any amounts the beneficiary receives are fully taxable.

Taxation to the Beneficiary at the Annuitant's Death (Pre-Annuitization)
In cases where the owner is the same as the annuitant, what happens at the annuitant's death is governed by the rules applicable at the owner's death. In cases where the annuitant is different from the owner and the annuitant dies first, federal tax law does not require that taxes be paid unless the contract terminates, which many do. However, recent clarification on this issue by Congress and the IRS has given insurers confidence to design contracts that survive the death of a non-owner annuitant by naming a new annuitant. Often this is the owner or contingent annuitant.

One important exception to this occurs when the owner is a "non-natural" person, such as a trust. In these situations, the death of the annuitant results in exactly the same tax treatment as the death of an owner.

Tax-Free 1035 Exchanges for Annuities

Section 1035 of the U.S. tax code allows an individual to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in a current variable annuity account. These tax-free exchanges, known as 1035 exchanges, can be useful if another annuity has features that are better or more fitting, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices.

The disadvantages of exchanging annuities, is that surrender charges on the old annuity may be assessed if still applicable, and a new surrender charge period, which may be as long as 10 years, may begin on the new annuity. The fees and expenses must be compared as well as benefits of the annuities before making the exchange.

The Underlying Investment

An annuity is an investment product that has an insurance policy packaged with it. The investment portion allows one to spread his or her money among one or more funds which are often referred to as sub-accounts. In the case of a fixed annuity, the individual's money may be invested by the insurer through its general account.

Payout Options

Annuities can be purchased by single payments or flexible payments. They can also be purchased as immediate annuities, where the yield is earlier, or as deferred annuities, where it is delayed. Annuities are not insured by the FDIC and are not bank guaranteed. However, they are one of the most popular sources of regular periodic income to most people who are spending their post-retirement years.

Many different payout options are offered to the person to be insured by the insurers. Common structures provide for payments either for (1) the rest of one's life, or (2) as long as the annuitant or a spouse is alive, or (3) a set period (such as 5, 10, 15 etc. years). The annuity payments are usually monthly. More specifically, let's look at the details for the various payout options below.

There are a number of payout options for receiving income from an annuity:

- **Lifetime Income for Annuitant --** One can take the option for income, guaranteed by the insurance company. This would be for the entirety of life, also. Payments cease upon death. This is called a straight life option.
- **Lifetime Income with a Guaranteed Period --** This type of annuity option is a life annuity with period certain. The individual will receive income for life. This income is also guaranteed by the insurance company. However, if the annuitant dies before the guarantee period is over, beneficiaries will receive the remaining number of payments left in the annuity.

- **Lifetime Income for Two –** An individual can also choose the option for income guaranteed for the entirety of life and the life of another person. This person could be someone such as a spouse. Guaranteed income for two people is known as a joint and survivor option. This particular option guarantees that income payments will continue for the life of the primary owner

and also in the life of a second person. The insurance company issuing the annuity makes the guarantee.

- **A Variety of Options --** There are many other options that may be mixed and matched together to provide an ideal income plan for specific needs of an individual at whatever age he or she may need it. An individual and a spouse may retire at age 65 with 10 years left on a mortgage so they can choose the option to have income for two people with a 10-year guaranteed period. With this option, if both die before the guarantee expires, the payments would continue until the end of the 10-year period to pay the mortgage for heirs.

Surrenders and Surrender Charges

Surrender is the act of getting money out of an annuity. There is, normally, a fee if one surrenders the annuity within the first seven or eight years of owning it known as a contingent deferred sales charge (CDSC). It can be also referred to as a back-end sales load. Most deferred annuities have surrender charges which allow annual withdrawals of 10% of principal per year without a penalty.

Cashing in an annuity before age 59 ½ can be expensive since the IRS will impose a 10% penalty on the monies withdrawn. This 10% penalty does not apply to payments made on account of disability or death, or to certain payments that are part of a series of substantially equal periodic payments over life or life expectancy when only that portion of the payment representing growth or interest income is taxed. ***Due to the 10% IRS penalty for money taken out before one reaches age 59 ½, most insurance companies allow the individual to withdraw up to 10% of assets before they impose a surrender charge***. Because of the combination of surrender charges and a possible 10% penalty an annuity must be viewed as a long-term investment.

Annuitizing a Deferred Annuity

When an individual begins taking payments from an annuity, he or she has "annuitized" it. The vast majority of deferred annuities are never annuitized. Because of this, the earnings are not paid out during the owner's lifetime. But the income tax liability does pass on to the heirs.

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The Insurance Feature

The insurance feature in a variable annuity promises that if an individual dies, his or her heirs will receive at least the premiums which were paid into the account. A part of the expense built into the variable annuity is the cost of the insurance feature. Independent studies report that this insurance coverage is often either worthless or much more expensive than if it were purchased separately.

The Costs of Annuitizing Retirement Payouts from Individual Accounts

A crucial questions about the operation of "individual accounts" systems of retirement savings is clearly how participants will draw down their account balances after reaching retirement age. Most of the defined-contribution plans may not specify how accumulated assets will be drawn down but, most defined-benefit plans are sponsored by private companies or by the government provide retirees and have mandatory life annuities. To contrast the public and private plans, private pension plans purchase these annuities as part of a group annuity contract with an insurance company or underwrite the annuities themselves whereas the public pension plans such as social security, are underwritten by the government.

Some current participants in defined-contribution plans wish to obtain life annuities. The annuities purchased with funds from accounts in these pension plans are individual annuities purchased through the group plans. If an individual participates in a pension plan that does not offer life annuities and nevertheless desires such a distribution method, it is necessary to purchase an individual life annuity through an agent or a broker representing a commercial insurance company. The costs of such annuities includes both administrative and sales costs, the "adverse-selection" costs associated with voluntary purchase behavior, and return on capital for the insurance company offering the annuity policy, affect the retirement income that the participant receives for a given level of wealth accumulation.

Tax-Deferred Money

The money that accumulates in an annuity grows tax-deferred, meaning the annuitant does not pay taxes on it until the annuity payments begin. The death benefit on the annuity is also taxable to the beneficiary. Once an individual receives payments, his or her gains are taxed at an ordinary income tax rate.

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If an individual dies before he or she annuitizes, the beneficiary pays taxes on the death benefit. In either case, the person who receives the money (the annuity holder or the beneficiary) is taxed at his or her ordinary income tax rate. The ideal annuity buyer is normally about 55 or older.

Annuities are less attractive to younger investors. The reason for this is because of the 10% penalty tax if money is withdrawn from an annuity before age 59½ unless it is for death or disability. Individual who have already retired and need annuity income right away can select the options for immediate annuities. The immediate annuity which skips the accumulation phase begins to issue payments as soon as one invests in the contract.

The ideal annuity buyer is a person who has already contributed the maximum amount to their existing tax-deferred retirement plan, such as a 401(k), 403(b), or IRA. This can occur because an individual is already building up tax-deferred money in those plans, and also, those savings vehicles cost much less than an annuity.

Liquidity Options

An option is a financial instrument that gives the holder the right to purchase shares in a company at a certain set price (strike price) before a set date known as the expiration date. Options, however, trade far less frequently than other financial instruments such as stocks or bonds.

Most annuities allow one to withdraw either interest earnings or up to 15% per year without a penalty (although any withdrawal from an annuity may be subject to taxes and a 10% federal penalty if taken prior to 59½ years of age). Typically a surrender charge decreases over a seven-year period. Some annuities with surrender charges reward the investor by offering a “bonus”: the insurance company adds on average 3% to 5% to the amount of the principal. Bonus annuities typically have slightly longer surrender periods, and some charge a slightly higher fee than they charge for their standard annuity.

For investors who may need quick money, there are also annuities without any surrender charges. However, these annuities do not offer bonuses, and may also charge a slightly higher fee than the standard annuity. This was in exchange for 100% access to the individual’s money.

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Annuities with Withdrawal Penalties

“No-surrender” annuities allow one to withdraw either interest earnings or up to 15% per year without a penalty (although any withdrawal from an annuity may be subject to taxes and a 10% federal penalty if taken prior to 59½ years of age). Beyond that, most annuities have a surrender charge -- a penalty for making an early withdrawal above the free withdrawal amount. Typically this surrender charge decreases over a seven-year period.

Why would an individual choose an annuity with a withdrawal penalty? Well, some annuities with surrender charges reward the investor by offering a “bonus”: the insurance company adds on average 3% to 5% to the amount of the principal. For example, if Richard invests $10,000 in a bonus annuity the insurance company will add $300 to $500 to his annuity immediately.

The trade-off is that with a bonus annuity the surrender period is usually longer (eight to nine years in most cases versus the typical seven-year surrender). Be aware, some insurance companies charge higher fees on their bonus annuities, as compared with their standard products. Be certain to compare the annual fees of a bonus annuity to the standard or traditional (no-bonus with 7 years of surrender) annuity. Sometimes the life insurance company will raise their fees to pay for the bonus.

Annuities Without Withdrawal Penalties

For investors who may need spur-the-moment access to their money, there are annuities without surrender charges (no-surrender or level load annuities) -- these annuities have no penalty or charge for early withdrawal. (That said, even with a no-surrender annuity investors under the age of 59 ½ are subject to a 10% federal excise tax as well as ordinary income taxes on any gains. ***An individual can avoid any taxes or penalties, however, by making a 1035 Tax-Free Exchange to another annuity, regardless of age.)*** No-surrender annuities do not come with bonuses, and some insurance companies charge higher fees for their no-surrender charge products, so be sure to compare all fees before investing.

Advantages

The chief benefit of a deferred annuity is its tax-deferral. Funds left in the annuity are not taxed until they are withdrawn. When withdrawn, they will be taxed at ordinary tax rates. The chief benefit of an immediate annuity is locking in a monthly income stream.

Disadvantages

Among the disadvantages of deferred annuities can be high expenses (almost 1% more a year than mutual funds), high surrender charges during the initial years of a contract, and the tax burden they can impose on heirs. With fixed annuities (deferred or immediate) inflation can eat away at the value of the locked-in fixed payments.

High Expenses

Many annuities have relatively high expenses associated with their purchase. Annual expenses for annuities can exceed 2%. Portions of these premiums are used to cover mortality charges in the event an individual chooses to have his account converted into a life income. Almost no one does, so this is a waste of money. Other expenses include commissions, policy fees, and a variety of other one-time and annual charges.

Higher Taxes on Withdrawals

An annuity converts what may have been long-term capital gains, which are taxed at a maximum rate of 20%, to ordinary income, for which tax rates are as high as 35% (maximum federal tax rate as of 2006). An example could be if an individual bought a stock index fund then held it for twenty years. After that period of time this individual took his or her money out. The gains would be taxed at a maximum rate of 205 (18% for assets purchased after December 31, 2000, and held five years or longer

When he begins withdrawing money from his annuity after age 59½ , he will be taxed on a last-in-first-out basis unless he annuitizes his payments. This means that he will pay ordinary income taxes on all distributions until he has withdrawn all of his profits.

Limited Investment Choices

Another major disadvantage of annuities is limited investment choices. Most have two dozen or fewer choices. Some have many more, but that is still limited compared to being able to choose among the entire universe of mutual funds (over 10,000).

Potential Tax Penalties

The final disadvantage of annuities is that if a person had to take his money out before age 59½, he would incur a 10% penalty in addition to ordinary income taxes.

Withdrawal of Earnings

Withdrawals of earnings or other taxable amounts are subject to income tax and if made prior to age 59 1/2 may be subject to an additional 10% federal penalty tax. Early withdrawals have the effect of reducing the death benefit and contract value.

Chapter 5
Features and Benefits of Annuities

Annuity contracts provide a number of benefits. The annuity income benefit may be the dominant one, but other benefits are also important. Let's look at some of the annuity benefits below.

Annuity Income Benefit

Income payments are usually made monthly. Yearly, weekly, etc payment plans are also available. The amount of the annuity payments is based on two different items. One of the items is the value of the contract and the second item is the contract's "benefit rate." The annuity benefit rate depends on the individual's age, sex, and the specific features of the specific annuity which the individual chooses. Annuity contracts contain a table of guaranteed benefit rates.

Most companies periodically develop "current" benefit rates which are subject to change by the company at any time. The company will determine the amount of each payment according to the current benefit rates and if the guaranteed benefit rates would provide higher income payments, those rates will be used. The most commonly available annuity income benefits are:

- *Amount Certain* -- With an amount certain option, the insurer pays a fixed benefit amount for as long as the accumulated value of the annuity lasts.
- *Straight Life* -- Straight Life is an insurance product that makes periodic payments to the annuitant until his or her death, at which point the payments stop completely. It does not allow annuitants to designate a beneficiary but the Straight Life annuities may be bought over the course of the annuitant's working life by making periodic payments into the annuity. They may be also purchased with a single lump sum payment made at, or shortly after, the annuitant's retirement.
- *Life With Period Certain* -- ***With this option, the insurer pays annuity income benefits for a specified period of time (e.g., 10 or 20 years)***. The stated period over which the insurer will make the benefit payments is called the period certain. The annuity is paid as long as an individual is alive. If he or she dies before the end of the period referred to as the "certain period," the annuity will be paid to a beneficiary for the rest of that period. Even if the annuitant dies during this period, it will not affect the income benefit payments. When the period certain ends, so do the payments.

- *Joint and Survivor.* This option provides for fixed monthly income payments to be made throughout the lifetime of two (or more) persons. The annuity is paid as long as either the annuitant or another named annuitant is still alive. In some plan variations, the payment amount is decreased after the first death. A period certain may also be available.

Annuity Living Benefits

Variable annuities are unique in offering tax deferral, professionally managed investments and living benefits all in one product. Living benefits, optional and available for an additional fee, are guarantees to protect accumulated assets during one's lifetime and provide a regular stream of income during retirement. These guarantees are backed by the claims-paying ability of the issuing insurance company. It's possible to choose among a variety of riders that provide guarantees to protect the principal, the withdrawal amounts during the payout phase or the income base that determines the size of the lifetime income stream.

Guaranteed Minimum Withdrawal (GMWB)
This benefit guarantees the return of principal through withdrawals of a fixed percentage of principal. This occurs during a fixed period of time until the amount of the original investment has been withdrawn. This benefit guarantees a return of principal over time, through systematic withdrawals.

Some benefits also guarantee annual withdrawals for life, or for the life of the owner and the owner's spouse, in addition to guaranteeing the principal. Typically, the amount of the withdrawal is about 7% annually for a period of 14 years. During the guarantee period, withdrawals from the contract, including free withdrawals, regardless of the amount, may negatively affect the death benefit.

Withdrawals in excess of the free withdrawal provision may be subject to surrender charges. All withdrawals of taxable amounts are subject to income tax and, if taken prior to age 59½, may be subject to a 10% IRS penalty. Withdrawal provisions will vary by contract. Some benefits also guarantee annual withdrawals for life, or for the life of the owner and the owner's spouse, in addition to guaranteeing the principal.

Guaranteed Minimum Income Benefit (GMIB)
Generally this benefit guarantees income through a guaranteed minimum annual compounding rate, typically ranging from 4%-5%. At purchase, the insurance company guarantees income through a fixed annual compounding rate. After a

vesting period, if the contract is annuitized, the guaranteed income base is used to calculate minimum monthly payments, regardless of market performance. If contract value grows, the income stream may be higher—but never lower—than the guaranteed amount. The rate of between 4% and 5% is guaranteed regardless of market conditions. Typically, a 10-year holding period applies. Guaranteed Minimum Income Benefit riders require that the contract be annuitized to access the benefit.

Guaranteed Minimum Accumulation (GMAB)
This benefit guarantees return of an initial investment, regardless of actual market performance, provided one holds the investment for ten years and make no withdrawals during that time. Generally, this benefit guarantees the initial investment. At the end of the vesting period, typically 10 years, if the contract value is below the initial investment, the issuer will add the difference between the current contract value and the initial premium (minus withdrawals).

An individual is guaranteed to receive back at least what he or she invested. At the end of the vesting period, the benefit may be exercised, expired or renewed, depending on the terms of the contract. If the benefit is not exercised or renewed, the guaranteed amount will become subject to market risk and may lose value. If the benefit is renewed it will trigger the start of a new vesting period. Additionally, some contracts mandate that all of one’s assets be allocated in specified investment options to access the benefit.

Death Benefit

Another important feature of some annuities is the death benefit provision, a feature inherent in most every annuity in one degree or another. Most contracts provide that, if an individual dies before the annuity payments start, the contract value will be paid to a beneficiary. Some contracts provide that the death benefit will be the total premiums paid if that amount is greater than the value of the contract at death.

An annuity has a death benefit, although it is not like one found in a life insurance policy. If an individual dies before he or she annuitize, the beneficiary will receive either the current value of the annuity or the amount that has been paid into it, whichever is greater. Once an individual begins to receive monthly payments, he or she no longer has a death benefit on the contract.

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For example, if this individual annuitizes at age 65 and die at age 67, the insurance company keeps the money in the contract. However, one can buy "term certain" annuities, which guarantees that either the annuitant or the beneficiary will receive payments for a certain period of time, such as 10 to 15 years.

The annuity issuer guarantees at a minimum that upon one's death the total premiums are paid to the beneficiaries. Many annuities "step-up" on the anniversary of the date the annuity was purchased, to the highest value at any preceding anniversary; or guarantee a minimum 5% to 7% interest compounded annually, and some will even combine the greater of the two features.

"Stepped-Up" Death Benefits
If one dies before receiving income from an annuity, the death benefit provides the beneficiary with a guaranteed benefit, one that does not have to go through probate. Some contracts offer optional "stepped-up" benefits which guarantee a minimum yearly percentage increase for the account and/or a minimum return on the value of the account. Death benefits are backed by the claims-paying ability of the issuing insurance company.

Waiver of Premium Benefit
Some companies offer a benefit which will pay premiums for an individual if he or she becomes disabled. A charge is made for this benefit.

Crisis Waivers
If an individual with an annuity gets seriously disabled or needs to go to a nursing home, the annuity contract can contain a waiver that triggers payments or withdrawals that are not subject to the usual surrender fees. Serious health changes, such as a chronic long term are illness, may also trigger annuity payments. Generally speaking, they seem to be more common and generous in fixed annuities, rather than variable contracts.

Situations that trigger the waiver and allow an individual to make early annuity withdrawals vary. For instance, one insurer might require a 90-day nursing home confinement before benefits are activated, while another might call for 60 days. In addition, one company may consider that an individual is disabled if he or she is unable to work in any occupation, while another may require that he be unable to work in his or her particular current occupation.

Beneficiary Protection

Should an individual die before receiving the income from an annuity, a beneficiary will receive a guaranteed benefit amount. This benefit amount is backed by the financial strength of the insurance company. Some contracts may also offer “enhanced” or “stepped-up” death benefits. Costs for these optional features will vary depending on the benefit. These types of death benefits are designed to "lock in" the investment performance. The product prospectus can give more information about death benefit options, restrictions and limitations. Annuities are insurance products. As such, their assets do not have to go through the time-consuming probate process, as long as there is a named beneficiary. The insurance company pays death benefits directly to the beneficiaries.

No Contribution Limits

Each year, the amount one can contribute to qualified plans such as an IRA or 401(k) is governed by IRS rules. For 2006 the maximum amounts are $4,000 for an IRA and $15,500 for a 401(k). Nonqualified annuities have no such limits on contributions. Additionally, there are no required minimum distributions for annuities held outside of qualified accounts. Annuities make it possible to save more on a tax-deferred basis, and make contributions and withdrawals when an individual likes.

Annuity Rider

An annuity rider is a feature on an annuity that provides an additional benefit. For example, a long term care rider would cover nursing home costs. ***A bonus rider would give an extra 1 to 5% of an investment upon buying the annuity***.

The Power of Tax-Deferred Compounding Benefit

One major benefit of an annuity is that all earnings are tax-deferred until the annuitant decides to withdraw them. Tax-deferred compounding provides the opportunity to defer taxes until the time of withdrawal. This gives the additional principal the time needed to work for the individual in his or her investments to potentially accumulate a larger pool of assets from which to draw on during retirement.

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The tax deferral associated with an annuity is already provided for by the qualified plan. For an additional fee, the annuity offers three more benefits. These benefits are death benefit protection, optional living benefits and the ability to receive a lifetime income. There is a difference between $10,000 invested tax-deferred earning 9% a year versus the same investment with a total annual income tax bite of 33% for 30 years. Even after taxes at withdrawal, the annuity earnings would be 1½ times as much as the fully taxed earnings.

Annuity Fees and Charges

Like other investments, annuities have fees and expenses. What distinguishes them from most *good* investments, however, is that annuity fees are quite high, thus drawing a great amount of bad press. Costs do vary from product line to product line and company to company, and that variable annuities have more features than fixed annuities, so fees and expenses within a variable annuity are generally higher than those found in fixed annuities.

There are many fees attached to every annuity contract. Some companies do not charge an initial commission, or load. Instead, they levy a substantial surrender charge of as much as 10% of the principal if an individual wants to cash out or transfer an annuity to another company within the first five or 10 years of the contract. However, some annuities permit a free withdrawal after the first year and for every year thereafter that surrender charges apply. This allows one to withdraw a certain portion (usually 10%) of the accumulated account value.

Charges

There are many types and amounts of charges. Companies may refer to these charges by different names such as "front loaded," (most of the costs to the company are charged to the individual in the beginning); or "back loaded," (most of these costs are charged later on). Others spread their charges evenly throughout the life of the annuity. Some companies apply charges to be fixed by the contract while some may be changed from time to time. It is important to know all the charges before buying an annuity. It is also important to know when they will need to be paid. A typical contract might contain one or more of the following types of charges:

Percentage of Premium Charge -- This charge is referred to a "load," and is deducted from each premium before any interest is added. The percentage may be reduced after the contract has been in force for a certain number of years

which the insurance company chooses. Or after the total premiums paid have reached a certain level it may be reduced.

Surrender Charge – The surrender charge is usually a percentage of the value of the contract or of premiums which are paid. It is possible to have the percentage reduced or eliminated after the contract has been in force for a certain number of years. The charge may be reduced in the interest rate credited or eliminated if the interest rate declared by the company falls below a certain level.

Mortality and Expense Charges -- The first fee which is usually imposed by an annuity will be what's known in the industry as a "mortality and expense" (M&E) charge. The items which this fee pays for are the insurance guarantee, commissions, selling, and administrative expenses of the contract. In general, these fees in a variable annuity will be charged as a percentage of the average value of the investment and will probably be quoted in terms of “basis points.”

Charges on Withdrawals -- Withdrawals are subject to income tax and, prior to age 59½, withdrawals would be subject to a 10% penalty tax by the IRS. ***Annuity surrender charges do not apply to immediate annuities since after the purchase, it cannot be surrendered***. Most annuity sellers also charge annual maintenance fees of $25 to $50. In fact, many experts say that an individual needs to own a variable deferred annuity for at least 15 years to make it a more worthwhile investment than doing so on one’s own with, say, a mutual fund. That number is somewhat less for fixed annuities, but it’s still something to consider.

Interest-Only Penalty-Free Withdrawals -- Annual penalty-free withdrawals might exclude principle.

Free Withdrawal Allowance
Fixed annuities commonly feature an annual 10% free withdrawal allowance, which is a great feature, but some contracts limit this allowance to income earned. This means one can withdrawal up to 10% per year penalty-free, but only of income earned.

The rollup base consists of all purchase payments including any associated purchase payment bonuses, if any, received during the first contract year up to $750,000. However, if an individual takes a withdrawal that is more than the annuity’s free withdrawal allowance or required minimum distribution, then the rollup base amount for any future rollups will be reduced to the account value of the annuity immediately after the withdrawal, if lower.

Withdrawals reduce the Benefit Base Amount (BBA) in proportion to the account value reduction. If it is within the free withdrawal allowance, the rollup base is not affected. On the other hand withdrawals reduce the BBA in proportion to the account value reduction, but the free withdrawal amount does not reduce the rollup base.

Fees

Contract Fee -- This is a flat dollar amount charged either once at the time of issue, or some companies may charge it once each year.

Transaction Fee -- This is a fixed charge per premium payment or other transaction.

Management Fees -- Management fees on sub-accounts are assessed by variable annuities, and they are the same as an investment manager's fees in a mutual fund. These fees will vary depending on the various sub-account options within the annuity. In general, they will be somewhat less than those charged by a managed mutual fund within the same investment category -- though not necessarily. According to NAVA, the 1997 industry average for sub-account management fees was 82 basis points, or 0.82%. That's somewhat lower than many managed stock mutual funds, but it's over four times that of an unmanaged stock index fund like the Vanguard Index 500, which only charges 18 basis points. Also, the returns published by an insurance company for its annuity sub-accounts will be the net returns after all management fees have been deducted.

Chapter 6
Defining The Annuity Portfolio

The Amount to Invest In An Annuity

Of these, the most important is an immediate actual and potential financial needs. If an individual is buying a deferred annuity and has a sudden need for cash, he or she can usually withdraw a small amount without penalty. However, one will likely pay a penalty if he or she makes a large withdrawal within a few years after buying the annuity. If an individual is buying an immediate annuity, he or she usually can't get any more than the regular payments, no matter how badly cash is needed. However, if an individual has other sources of cash that are sufficient for any emergency or unforeseen needs, then the immediate needs criterion is satisfied and the other criteria become more important.

- Immediate actual and potential financial needs;
- Long-term financial goals;
- Current savings/investment portfolio;
- The range of alternatives available.

An annuity is a contract sold by an insurance company designed to provide payments to the holder at specified intervals, usually after retirement. The holder is taxed only when they start taking distributions, or if they withdraw funds from the account. All annuities are tax-deferred, meaning that the earnings from investments in these accounts grow tax-deferred until withdrawal. Annuity earnings are also tax-deferred, so they cannot be withdrawn without penalty until a certain specified age.

Fixed annuities guarantee a certain payment amount, while variable annuities do not, but do have the potential for greater returns. Both are relatively safe, low-yielding investments. An annuity has a death benefit equivalent to the higher of the current value of the annuity or the amount the buyer has paid into it. If the owner dies during the accumulation phase, his or her heirs will receive the accumulated amount in the annuity. This money is subject to ordinary income taxes in addition to estate taxes.

Building the Portfolio

Annuities may help provide additional retirement income by allowing the accumulation of tax-deferred savings and then at a later time to receive periodic

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payouts for a specified period of time. Annuities are commonly used to supplement a monthly retirement income already received from an IRA and 401(k) plans. The addition of an annuity to a portfolio may create the ability to defer income taxes or create an income guaranteed for life. The terms of the annuity contract should be reviewed carefully with attention paid to the guaranteed values, the annual charges or expenses, the method of calculating interest or return, and the surrender charges. Some annuities never allow access to the full account value without taking an income payment option.

The numerical results show that the presence of health spending risk drives households to shift their portfolios from risky equities to safer assets and works to enhance the demand for annuities due to their increasing-with-age superiority over bonds as a hedge against life-contingent health spending as well as longevity risks. These should be avoided due to the excessive cost and limited access to funds.

Finally, evaluate and choose a financially strong insurance company to back the annuity. Any guarantees in the contract are backed only by the strength of the issuing company. When one buys a variable annuity to augment a portfolio, the money is allocated among a number of investment portfolios. The investment portfolios are mutual funds, either designed specifically for the annuity company or similar versions of existing funds designated for retirement accounts. Although the names of the investment portfolios may be similar to those of mutual funds available generally to the public, they are not the same funds.

Aggressive growth, growth income, and international stock portfolios would tend to provide an investor with greater returns than fixed-income funds, so it makes less sense to buy a variable annuity if one does not want to invest in these kinds of portfolios. The variable annuity is where the most aggressive part of one's portfolio should be, provided he can tolerate a risky component.

Portfolio Strategy

Structured Portfolio Strategy is for a portfolio designed to match or exceed the performance of some specific liabilities that will need to be paid out in the future. The strategy an individual chooses must meet personal requirements and investment profile. As with any portfolio, strategy is all-important. The active portfolio strategy is an investment strategy adapting to changing market which gives an approach to investment where the make-up of a portfolio is frequently revised as market conditions change.

The passive portfolio strategy is the investing of relying on diversification. It is an investment strategy that involves minimal expectational input, and instead relies on diversification alone to match the performance of a particular market index. The strategy assumes that the marketplace already reflects all available information on the price of the securities.

Rebalancing is the periodic adjustment of a portfolio to restore the original asset allocation mix. In order to maintain the strategy best-suited for an individual, a portfolio is re-balanced as needed. Rebalancing a portfolio on a regular basis maintains the desired asset allocation in the investment strategy -- it is one of the important keys for effective risk management. This guarantees that one's risk does not increase over time.

Rebalancing forces the investor to trim back on winners and increase undervalued categories -- a principal of buy low, sell high. The investment strategies and objectives of each individual portfolio, and as illustrated and explained in each individual prospectus, create the philosophy in which investments are made. The fund manager uses it to steer his investments in the right direction, and the investor utilizes it to choose the right vehicle for his investments and personal financial goals.

Should dollar-denominated assets fall in value, an individual's portfolio will have other currency holdings to mitigate in full or in part the effects of such a fall. The managed annuity portfolio can be constructed in at least four different styles:

- Fixed-Income;
- Conservative;
- Balanced;
- Dynamic.

Although asset class diversification is thought to be largely responsible for investment performance, many investors fail to recognize that individual asset classes have historically performed differently under different sets of market conditions. By setting a static allocation for the life of a portfolio, an investor may be missing opportunities to enhance performance and/or reduce volatility. Today, investors need to mix things up and get exposure to different asset classes to keep their portfolio incomes high, reduce risk and stay ahead of inflation.

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Fixed-Income Portfolio

Fixed-income investing often takes a backseat to the fast-paced stock market, with its daily action and promises of superior returns. However for the retired investor fixed-income investing must move into the driver's seat. A Fixed-Income Portfolio seeks to achieve a stable real value of invested capital with minimum risk by investing in U.S. government obligations, etc. It focuses on maintaining a portfolio of debt obligations with a weighted average length of maturity of one year.

At this stage, preservation of capital with a guaranteed income stream becomes the most important goal. For investors using the capital preservation strategy to achieve their goal, they must ensure their portfolio is producing a return that is at least equal to inflation. Individuals who are close to or within their retirement years often prefer these portfolio strategies so they can ensure their life savings are not lost or reduced for any reason other than their own withdrawals - which they need for living expenses.

A portfolio that invests in one economic sector or geographic region may involve more volatility. Fixed income can be broken down into five asset classes: government-issued securities, corporate-issued securities, inflation-protected securities (IPS), mortgage-backed securities (MBS), and asset-backed securities (ABS). An enormous amount of innovation continues within the world of fixed income.

In today's ultra-low interest-rate world, fixed-income investing has become much more complex. The days are gone where an investor could invest in U.S. Treasuries at 8%, sit back, and let the income roll in. A portfolio that invests primarily in aggressive, small capitalization stocks may involve more volatility and risks. Aggressive investors place a higher percentage of their assets in equities rather than in safer debt securities.

As such, aggressive investors build portfolios that bear a fairly high amount of risk. But before assuming this strategy, an investor should evaluate his or risk tolerance - making sure it's high - and be sure that he or she has quite a few years before needing the invested funds. While foreign stock prices are subject to the same influences as domestic stocks, international investing can involve additional risks and expenses which can increase the potential for losses in the portfolio.

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Portfolio Diversification

Regardless of its potential for retirement income, a fixed annuity can provide stability in a portfolio, providing fixed income no matter what happens in the stock market. Portfolio diversification can be a valuable stock investing concept for every investor whose ultimate goal is to maximize profit and minimize risk. The principle of maximizing profits and minimizing risks is so simple, yet its practice is seemingly an impossible task.

The best protection against risk is portfolio diversification; investing in multiple investment options instead of choosing to place all the investments in only one area. A well-diversified portfolio will contain most, or all, of the following: stocks, bonds, mutual funds, cash equivalents like Treasury bills or money funds, as well as other types of investments. Being able to diversify over a broad range of investment options can help minimize many of the dramatic ups and downs in investing.

The High Yield Portfolio invests primarily in high yield, lower-rated corporate bonds. The Portfolio typically invests a majority of its assets in high yield bonds (commonly referred to as “junk bonds”). Although high yield bonds typically have a higher current yield than investment-grade bonds, high yield bonds are also subject to greater price fluctuations and increased risk of loss of principal than investment-grade bonds. Annuities can accommodate qualified or non-qualified money.

The Importance of Annuity Asset Allocation

Asset Allocation *is the placement of a certain amount of one's investment capital within different types of asset classes* (e.g., 50% stock, 30% bonds, and 20% cash). The goal of asset allocation is to diversify investments across different types of investment classes in order to balance potential rewards and probable risks. Some analysis focused on strategies in which the investor makes a one-time annuitization decision and selects a single asset mix for non-annuitized assets.

Further research needs to be done to explore dynamic annuitization and asset allocation strategies during retirement in the presence of uncertain inflation. Studies have shown that what investments chosen or when they are invested is not nearly as important as how that individual diversify his or her money across different asset classes. The key to retirement investing is to assume as much risk as one can comfortably tolerate, but no more. If the investor takes on too much

risk, he or she will be prone to overreacting to the market and that is one of the behaviors that significantly reduces investment earnings Historically, equities provide higher returns with the most volatility. All investments entail some degree of risk. Some investments have very limited risk but others, like highly volatile stocks, can be quite risky. To balance reward and risk, an individual may want to diversify among asset classes.

Once the right mix of assets has been determined across equities, fixed-income securities and short-term instruments, an individual may want to consider further diversifying the equity portion of annuity assets across sub-classes, namely large-cap, small/mid-cap, and international equities. When selecting domestic equity portfolios, two factors to consider are market capitalization and valuation. Market capitalization reflects the value of the companies' stock in which the portfolio invests. Domestic equity portfolios are divided into three capitalization ranges of Large Cap; Mid Cap; and Small Cap.

Valuation is the process of estimating the market value of a financial asset or liability. Valuations can be done on assets or on liabilities Valuation indicates whether the majority of the portfolio's assets are invested in growth stocks, value stocks, or a blend of the two. The process of determining the current worth of an asset or company has many techniques some of which are subjective and others are objective. The two factors of capitalization and valuation can be combined with three concepts to create different equity blends. These equity blends are Value; Blend; and Growth.

Dollar Cost Averaging

Dollar cost averaging is an investing technique intended to reduce exposure to risk associated with making a single large purchase. The idea is simple: spend a fixed dollar amount at regular intervals on a particular investment or portfolio/part of a portfolio, regardless of the share price. This systematic investment program may help smooth out the highs and lows of a volatile stock market.

Variable annuity is well suited to carry out this strategy because it allows a specified portion of a lump-sum investment typically deposited into a fixed-rate account to be transferred tax-free on a monthly basis into equity portfolios, where there is the potential for higher returns.

There is a better way to invest in today's weird, topsy-turvy market and that is through dollar-cost averaging (DCA). This idea of investing on a regular schedule

over a lengthy period, in order to capture lower as well as higher prices during periods of volatility, seems plain common sense.

Dollar-cost averaging is similar to, but not the same thing as, investing regularly scheduled amounts, such as contributions from every paycheck to a 401(k) plan. It's the alternative to investing a lump sum, such as an inheritance or an IRA rollover, typically over four calendar quarters. By making regular investments, an individual is ultimately able to buy more units when prices are down and fewer units when prices are up-resulting in a lower unit cost.

Dollar Cost Averaging replaces emotion with consistency and helps reduce market risk. This technique can help secure a lower average unit cost and provide increased earnings potential when the investor is able to invest a fixed amount on a regular basis. This investor must be able to invest consistently regardless of market fluctuations.

Underlying Portfolios

The portfolio's ability to achieve its objective depends largely on the performance of the underlying portfolios in which it invests. Underlying Portfolios are those in which each Asset Allocation Portfolio invests based on established principles of asset allocation and risk tolerance. Each underlying portfolio's performance, in turn, depends on the particular securities in which that underlying portfolio invests. Accordingly, the portfolio is subject, indirectly, to all the risks associated with its underlying portfolios.

Underlying portfolios may have existed prior to the inception of the subaccounts. Performance regarding such subaccounts is calculated using the actual fees and charges of the product as if such product was available since the inception of such subaccount. With variable immediate annuities, the payment is based on the value of the underlying investment, usually a stock portfolio. Non-standardized performance is calculated from the underlying portfolio's inception date which may be different from its adoption in the contract. Performance that predates the adoption of the portfolio in the contract is hypothetical.

Issuer-Specific Changes

Changes in the financial strength, or perceived financial strength, of a company may affect the value of its securities thus indirectly impact the value of the portfolio's shares. The value of an individual security or particular type of security

can be more volatile than the market as a whole and can perform differently from the market as a whole. The lower-quality debt securities and certain types of other securities can be more volatile due to increased sensitivity to adverse issuer, related to the political, regulatory, market, or economic arena and can thus be difficult to resell.

Tailoring Variable Annuity's Investment Mix

An important consideration is aggressive growth, income growth, and international stock portfolios as they would tend to provide an investor with greater returns than fixed-income funds. Consequently, it makes less sense to buy a variable annuity if one does not want to invest in these kinds of portfolios. The variable annuity is where the most aggressive part of the portfolio should be if he or she can tolerate a risky component. ***The actively managed portfolio seeks high current income and, secondarily, growth of capital by investing primarily in high-yielding ("junk") corporate bonds.***

Generally, the longer an individual has to maintain an annuity, and the greater one's comfort is with risk, the more an allocation may be weighted toward equities. An individual can diversify by:

- ***Market Capitalization and Valuation*** -- indicates whether the majority of the fund's assets are invested in growth stocks, value stocks, or a blend of the two. Market capitalization is a measurement of corporate or economic size equal to the share price times the number of shares outstanding of a public company.

- ***Concentrated funds*** -- limits the fund manager's holdings to 20-40 companies. These funds may be subject to more dramatic shifts in performance. Concentrated funds were among the industry's best performers. Concentrated Mutual Funds hold a small number of stocks, which are generally limited to just a few sectors that the manager thinks will outperform the rest of the market. These funds are also much more volatile than broader market funds.

- ***Investing in Sectors*** -- invest in a particular industry sector that has the potential to offer the potential for long-term growth. The investor must understand that the sector funds are not appropriate for every annuity owner. They definitely should not comprise the entire annuity allocation.

Summary

An investor should review an annuity portfolio as often as other investments. ***Depending on the type of annuity, one should review it at least once a year***. Of course, a major change in a family such as a serious illness, a new baby or even starting a business should trigger a review. If any plans are changed, the investor must find out whether this will be an additional cost.

Though variable annuity contracts offer different options the investor will have a choice among these major categories: equity, bond, money market, and balanced portfolios. Many contracts also have a *fixed account*. Each contract typically offers at least one investment portfolio in each category, and frequently more than one. When there is more than one, each portfolio will often have a somewhat different investment objective from the others as well as different strategies for achieving the portfolio's objectives. A portfolio can fit allocation goals more precisely.

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Chapter 7
Uses of Annuities

Annuities are used for a variety of reasons, including retirement savings and other long-term savings purposes such as business planning. While annuities can be useful in many different endeavors, they may not always the most appropriate financial product to meet a need. It is important to understand both the advantages and the disadvantages of using an annuity in many different situations and at different times in one's life.

Annuities to Shelter Nonexempt Assets

The assets of a married couple that exceed the community spousal resource allowance, and income that in excess of the minimum monthly maintenance needs level must be disposed of if the sick spouse is to become eligible at an early date for Medicaid benefits. Realistic needs of the well spouse should be examined to determine if this strategy is possible.

Asset spend-down is available, but is not very attractive to the proponent of wealth preservation, unless the expenditure is used to increase the value of an exempt asset. The annuity has become a more appealing approach as there are many annuity planning options which need to be analyzed for the applicable advantages and disadvantages. The tax impact of liquidating assets to convert them to an annuity must be evaluated as well.

Medicaid guidelines for the use of annuities clarifying COBRA '93, state that annuities must not be guaranteed for a period longer than the actuarial life expectancy of the annuitant. If they are, the payments that are guaranteed to be made later than the end of the actuarial life expectancy represent a transfer and will be penalized as such when the annuity is established. To avoid transfer penalties, guarantee periods of annuities must take into account the new guidelines concerning actuarial life expectancies.

Annuities for Income

Immediate annuities are specifically used for generating income. An individual deposits a fixed dollar amount and receives a guaranteed income stream for a variety of different time frames including the rest of both spouse's life if so desired. ***Most of these annuities credit in the vicinity of 3% to the cash values remaining in the annuity while the annuitant is receiving the income. If an***

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individual's time frame is 10 years or longer, it is wise to look at a variable immediate annuity. When working with a longer time frame, an individual can account for the market swings and receive a larger pay out.

Retirement Planning

Although the nonqualified annuity can be used for many purposes, probably its best and most frequent use is retirement planning. The three basic features of annuities can aid retirement planners. The three basic features of annuities include:

- their income stream -- which is guaranteed to last as long as the contract holder lives;
- their ability to function as a long-term savings plan -- which investments grow tax-free; and
- their higher level of protection against investment losses.

With retirement accounts battered by the bear market, guaranteed income from a fixed annuity now has more appeal. Obvious, a guarantee of a 3% or 4% return is better than the prospect of a 20% loss in the market. Either way, brokers cannot afford not to know about annuities and how they work. Saving for retirement is the most common use of annuities. Tax-deferral benefits will allow dollars to grow faster than a comparable taxable investment. An annuity can be an excellent tool for this purpose. Some reasons why to consider an annuity for retirement savings:

- Annuitized payouts if chosen, continue until death.
- IRAs place a limit on contribution amounts. Annuities do not have a limit on the amount of funds that one can invest in the annuity.
- IRAs require the holder to begin receiving minimum distributions at age 70½. Annuities do not have minimum distribution requirements.
- If an individual works for a small company or is self-employed, he may not have access to a qualified plan. Annuities may be a way to supplement Social Security income during retirement.
- The earnings are tax-deferred.

Retirement has been the focus of much attention in recent years. Since people are generally living longer than at any time in history, there are more retirement years to be planned for and, particularly, to be paid for. Another reason for the focus on retirement planning is of course, the baby boomer generation. Born

between 1945 and 1964, those on the older edge of the boomers are now entering their 50's and beginning to plan seriously for their retirement years.

The result of these factors, and others, has been an increased interest in and focus on the financial aspects of retirement. Most Americans expect to receive Social Security benefits at retirement and many are fortunate enough to be participants in qualified retirement plans provided by their employers, although many who are self-employed do not have retirement plans.

However, experts warn that if the baby boomer generation is to afford the retirement lifestyle it seems to want, these two sources of retirement income will not be sufficient.

One of the best vehicles to accumulate funds to supplement retirement income from Social Security and qualified retirement plans is a nonqualified annuity. The use of the labels, “qualified” and “nonqualified” have nothing to do with the qualification of the annuity or the insurance company issuing it. Instead, these terms refer to whether the annuity is being used as part of a retirement plan that is "qualified" under certain sections of the Internal Revenue Code.

A “qualified” annuity is open which is used as part of or in connection with a qualified retirement plan. A “nonqualified” annuity is one which is not used as part of any qualified retirement plan. If the annuity is labeled as nonqualified, this simply means that it may be purchased by any individual or entity and is not associated with an employer-provided plan.

As with many financial planning strategies, earlier is better than later when deciding when to start saving for retirement. If the annuity holder, Mrs. Adair, begins saving for retirement at age 40, she will have accumulated a sum of $138,598 at age 65 by saving $200 each month. The same monthly amount started at age 50 would result in a retirement sum of $58,164.

Waiting until age 60, with retirement only five years away, severely cuts down on the available funds, resulting in a sum of only $13,954. If Mrs. Adair elected a life income settlement option under the annuity started at age 40, her monthly benefit payment would be $812. Under the annuity started at age 50, the benefit would be $341 while under an annuity started at age 60, she would receive only $82 each month.

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Business Planning

When an individual is self-employed or owns his or her own business, it is a good idea to consider an annuity to supplement their retirement. In the absence of a generous pension plan, an annuity can be used to fill in the gaps after having made the maximum allowable contributions to other available retirement plans if an individual plan to retire early. The only point to watch for is the 10% early withdrawal penalty.

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Chapter 8
Understanding Annuities and Taxes

Annuities & Taxation

The power of tax deferral can help money grow faster than a currently taxable investment earning a similar return. An individual pays no taxes on annuity earnings until they are withdrawn so the money keeps working until it is withdrawn. It will not be reduced by annual taxation. At a later time when the annuitant needs the money, only the earnings are taxed.

An annuity is a contract issued by an insurance company and usually referred to as an annuity policy or annuity contract. What makes annuities different is the tax treatment given them by the IRS. When money is placed under the umbrella or annuity contract, it is treated differently as far as taxes go. The money that an individual puts in an annuity is referred to as a premium. It is his original contribution or principal contribution. Since he already has paid taxes on it, it never again will be subject to taxation.

The money puts into an annuity will earn interest or receive dividend income or capital gain distributions. These “earnings,” unlike money in a savings account, mutual fund, or Certificate of Deposit, are not taxed in the year in which they are earned. Thus the “earnings” will continue to grow and compound tax free until withdrawn. The IRS does eventually collect taxes on the “earnings” of the annuity.

Customers are urged to seek advice from a personal tax advisor. Insurance agents are not trained or qualified to provide tax advice. There are gray areas where even tax attorneys disagree. It is not an agent’s role to be a tax practitioner but rather to be a helper to people so that they can accumulate more money. Understanding basic annuity taxation allows an agent to perform that role.

Annuity Tax Issues

Annuities may generally allow an investment to be held on a tax-deferred basis, but the individual investor should be aware of certain tax issues before purchasing an annuity.

- Withdrawals from annuities, including partial withdrawals and surrenders, may be taxable.

- Taxable distributions from an annuity are generally taxed at the contract owner's ordinary income-tax rate and do not get the benefit of the lower tax rates received by certain capital gains and dividends under current tax laws. The death of a contract owner or the death of an annuitant may result in taxable distributions that must be made from the contract within a specified period of time. Upon the death of the owner/annuitant of a contract:

  - Gains may be taxable to the beneficiary;
  - The annuity assets may be included in the owner's estate;
  - There is no step-up in the tax basis;
  - Annuity assets will bypass probate, unless the contract owner's estate is the named beneficiary or no beneficiary is named.

Annuitized Payments
If an individual annuitizes a nonqualified annuity, a portion of the payment will be considered a return of premium and will not be subject to ordinary income tax. The amount that is taxable will be determined at the time he or she elects to annuitize the policy. ***A calculation will be made by the insurance company to determine the "exclusion ratio,"*** which will determine the percentage of each payment that will be excluded from income tax.

Income received from a nonqualified annuity under a structured annuitization option is taxed in accordance with the exclusion ratio. The exclusion ratio treats each annuity payment as part principal and part interest, thereby excluding a portion of each payment from tax and taxing a portion. The exclusion ratio is the "investment in the contract" divided by the "expected return".

If the expected return is not based on a life expectancy – as would be the case with a fixed term of years option, – it is calculated simply by adding the total amounts to be received. If the expected return is based on a life (or joint life) expectancy, certain IRS-prescribed tables and multipliers are used to determine the total expected return.

Expenses can vary. This makes a difference in the income and in the taxation. Make sure that the annuity contracts have competitive fees. While cheaper does not necessarily mean better, still if a contract is too expensive it could offset gains from the tax-deferred status. All earnings from annuities are taxed as ordinary income. When the individual's ordinary income tax rate at retirement is higher than the current long-term capital gains rate for certain investments, unfortunately, he or she would actually pay higher taxes. There is, however a gain a tax deferral on

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earnings. With some other investments, one could be subject to ordinary income as well as capital gains taxes annually, even if the investment has not been cashed in. This can reduce the value of the earnings.

Contributions to a Nonqualified Annuity as Post-Tax Dollars

When contributing after-tax savings to an annuity, an individual can put an unlimited amount of money in. However, before putting after-tax savings into an annuity, many financial advisors recommend to put the maximum pre-tax amount into a retirement plan such as an IRA, SEP, 401(k) or 403(b) in order to fund them. There are laws and regulations regarding funding these vehicles to limit the contributions.

There are also federal tax laws that generally require that one begins taking minimum distributions by April 1 of the calendar year following the year when the investor reaches age 70½. There is a tax penalty of 50% of the amount of the shortfall if the investor fails to do this. Additionally, once money is in a 401(k) or 403(b) plan, one generally cannot make withdrawals before age 59½ except for special circumstances, such as severance from employment, death or disability. If there is an exception, withdrawals are subject to ordinary income taxes and may be subject to a 10% federal tax penalty for pre-59½ withdrawals.

How Payouts Are Taxed

The way payouts are taxed differs for qualified and non-qualified annuities. The tax treatment of annuities is dependent on whether it is a qualified or non-qualified annuity. Although both permit the tax-deferred growth of the investment and both have penalties for early distributions, they are governed under different sections of the IRC.

Qualified Annuity -- A tax-qualified annuity is one used to fund a qualified retirement plan, such as an IRA, Keogh plan, 401(k) plan, SEP (simplified employee pension), or some other retirement plan. The tax-qualified annuity, when used as a retirement savings vehicle, is entitled to all of the tax benefits—and penalties—that Congress saw fit to attach to such qualified plans.

The tax benefits can be described as any nondeductible or after-tax amount one puts into the plan is not subject to income tax when withdrawn, and the earnings on the investment are not taxed until withdrawal. If an individual withdraws money

from a qualified plan annuity before the age of 59-1/2, one will have to pay a 10% penalty on the amount withdrawn in addition to paying the regular income tax.

There are exceptions to the 10% penalty, including an exception for taking the annuity out in a series of equal periodic payments over the rest of one's life. Once reaching age 70½ , he or she will have to start taking withdrawals in certain minimum amounts specified by the tax law. The exception to the rule is for Roth IRAs and for employees still working after age 70½ .

Qualified Annuity Taxation -- Qualified annuities are treated no different than any other tax-qualified retirement investment. Growth of the investment, whether fixed interest or variable-based, escapes current taxation under one of the 400-series IRC sections. Additionally, if the funds are withdrawn prior to age 59½, there is a 10% penalty. As the money is withdrawn, every dollar is taxed as ordinary income. Finally, fund distributions must begin no later than April 1 of the calendar year following the year when the owner turns age 70½.

Non-Qualified Annuity -- A non-qualified annuity is purchased with after-tax dollars. The annuitant still gets the benefit of tax deferral on the earnings. However, he or she pays tax on the part of the withdrawals that represent earnings on an original investment. If one makes a withdrawal before the age of 59½, he or she will pay the 10% penalty only on the portion of the withdrawal that represents earnings. With a non-qualified annuity, an individual is not subject to the minimum distribution rules that apply to qualified plans after reaching age 70½ .

Non-Qualified Annuity Taxation -- The taxation of non-qualified annuities is generally contained within IRC § 72. The annuity is provided tax-deferred growth but along with that the 10% penalty for early withdrawal. The real key here is that the manner that distributions are taken will determine the nature of their taxation.

Tax on Beneficiaries or Heirs

If an annuity is to continue after one's death, other taxes may apply to a beneficiary (the person designated to take further payments) or heirs (an estate or those who take through the estate if he or she didn't designate a beneficiary).

- *Income tax: The a*nnuity payments which are collected by beneficiaries or heirs are subject to tax on exactly the same principles that would apply to payments collected.
- *Exception:* There's no 10% penalty on withdrawal under age 59½ ir-regardless of the recipient's age, or an individual's age at death.

- *Estate tax:* The present value at one's death of the remaining annuity payments is an asset of the estate, and it is also subject to estate tax with other estate assets. However, to be considered is the fact that annuities passing to a surviving spouse or to charity would escape this tax.

Tax Deferred Accumulation

An annuity is a contract between an individual and an insurance company that provides the individual with tax-deferred accumulation and an option to receive a lump sum or fixed periodic payments starting on a specific date. Whether buying an immediate, deferred, or variable annuity, the reason most people buy an annuity is because of its preferential tax treatment. As mentioned earlier, interest that accumulates on an annuity does on a tax deferred basis. So every year as the account values grow there is no tax to be paid. This allows more money to work during the accumulation phase and ultimately greater total accumulations.

Tax-deferred annuities allow for a higher effective investment return by accumulating income on a tax-deferred basis. Income tax on the investment growth is postponed until the money is withdrawn from the contract. If owned by an individual, all the earnings in an annuity are free of current federal, state and local income taxes until the individual begins to receive annual payments.

The consequence is that all earned annuity income compounds, without being reduced by current income taxes. Withdrawals of earnings are subject to ordinary income tax, and a 10% federal income tax penalty may apply if taking the distribution before reaching age 59½. ***A tax-deferred annuity offers the same benefits as a non-deductible IRA, but without the $2,000 contribution limit, the mandatory withdrawal requirement at age 70½***, and without all of the record keeping and reporting requirements.

Taxed Deferred Growth

Perhaps the most powerful tool of an annuity is the control that it gives one over his taxes. With an annuity, the income tax on interest earnings is deferred until one chooses to access his savings. By deferring the tax, he can immediately realize a decrease in his federal and state income tax. With no current taxation one earns:

- interest on principal;
- interest on interest; and

- interest on the money that would have been paid in taxes.

The 10% Penalty Tax

Just like an IRA, there is a 10% excise tax penalty on premature withdrawals for deferred annuities. The government extends tax advantages to the annuity for retirement purposes. The government also extends tax disadvantages to taxpayers who do not use the annuity for retirement. All interest withdrawn prior to the owner being age 59½ will be subject to a 10% excise tax penalty.

The government extends tax advantages to the annuity for retirement purposes. The government also extends tax disadvantages to taxpayers that do not use the annuity for retirement. As we have mentioned before, there is a federal income tax penalty of 10% which is imposed on early withdrawals of earnings from an annuity. However, now we need to look at certain exceptions which may apply.

This penalty will not apply to a distribution that is:

- Made to a beneficiary upon death;
- Made as a result of the taxpayer's becoming disabled;
- Made at the time, or after, the taxpayer attains the age of 59½;
- Made as part of a series of substantially equal periodic payments that are for life.

There are also additional tax considerations which an individual must be made aware of. If an individual desires to transfer an annuity to another person, it is necessary to ask about gift and income tax consequences. It is important to ask about “aggregation if a person wants to buy more than one annuity. If it is going to be important to move money from one annuity to another, a Section 1035 exchange should be considered in order to protect the money from the loss of certain tax advantages.

Methods to Avoid The 10% Tax

There are certain circumstances where the 10% excise penalty may be avoided:

- Disability of taxpayer;
- Distribution from a pre-8/14/82 annuity;
- Death of owner (but death of annuitant for annuities issued before 4/23/87);

- Payment from an immediate annuity where benefits commence within one year of purchase;
- Payment from a structured settlement; and
- Substantially equal payments over taxpayer's life expectancy.

The Mechanics of Taxes and Annuities

The most important thing to remember about annuity taxation is that as long as an individual does not take money out, there are no tax consequences for having an annuity. Not only are taxes not due during the accumulation phase, but one does not have to report the annuity on a tax return at all. When annuitants make withdrawals or begin the payout phase, he or she will begin getting 1099s. Two other important points regarding taxation:

- Whether an individual is in the payout or accumulation stage, any income actually received from an annuity is taxed as ordinary income rather than as capital gains.
- If an individual withdraws money prior to age 59½, he or she may be subject to an IRS tax penalty of 10% of the accrued earnings.

Variable annuities provide one with a diversified group of professionally managed portfolios, similar to mutual funds. An individual has the flexibility of allocating money among one or more of these portfolios. As the financial objectives change, then this individual can reallocate the assets tax-free. In fact, some variable annuity programs have an asset allocation program that automatically repositions ones assets according to market cycles, changes in the economy and his personal risk tolerance.

Like mutual funds or individual stock and bond investments, variable annuities do not offer guaranteed principal or a specific rate of return. However, unlike any other investment available today, in the event of one's death, variable annuities can offer the beneficiaries a guaranteed return, regardless of market performance. And, variable annuities provide an opportunity to participate in the high potential returns of the stock and bond markets.

Although one will also take on a degree of investment risk, the long-term nature of variable annuities allows him to "ride out" short-term market fluctuations. History has proven that over time, stocks and bonds provide higher returns than many other investments.

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Finally, depending on the variable annuity one chooses, in the event of his death, beneficiaries may be guaranteed as much as a 7% return. Of course, they will receive the market value of his investment if it is greater than the guaranteed value. The closer one comes to retirement, the more important it is to take advantage of investments that offer tax-deferred growth. Thanks to the tax-deferred compounding feature of fixed and variable annuities, one's retirement nest egg grows faster while his financial future becomes more secure.

Taxation at Death - Spousal Continuation

There are many variable annuities which enable a spouse to continue the policy when one spouse passes away. Some companies will pay the death benefit into the policy and continue the original policy without tax consequences. Others will require a spouse to choose either the death benefit (if the account value is lower than the death benefit) or spousal continuation. Choosing the death benefit in these situations would be a taxable event; a spouse would be taxed at ordinary income tax rates on the difference between the death benefit and the amount which was invested, adjusted for any withdrawals. In most cases, the policy would not be included in the taxable estate for estate tax purposes due to the marital allowance.

Taxation at Death - Non-Spousal Beneficiary

The Spousal continuation Rule [IRC 72(s)] states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. ***At the annuitant's death, the death benefit will be paid to the non-spousal beneficiaries who have been designated***.

By doing so, the transfer will avoid probate. Unlike most other securities, there is no step-up in cost basis at the time of death. Instead, any deferred income in the policy will be taxable to the beneficiaries as ordinary income at their tax rates. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC.

If a death benefit is paid out that is higher than the account value, the difference between the death benefit and the amount that has been invested, adjusted for any withdrawals, will be taxable as ordinary income to the beneficiaries. If anyone else is named as a Primary Beneficiary along with the Spouse then the option of becoming the Contract Owner and continuing is usually lost.

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The value of the variable annuity policy also will be included in the estate for estate tax purposes. Beneficiaries have the choice of taking a lump sum payment or receiving the payments over a period of time, thereby spreading out the income tax liability.

Wealth Transfer Issues
Regardless of whether it is a qualified or non-qualified annuity, extreme care must be given when specifying beneficiaries. There is no doubt that these investments have great potential for appreciating sizable amounts of wealth during a lifetime, but unfortunately they are very poor vehicles for the transfer of this wealth to successor generations after death.

This fact must be taken into consideration when setting up the Annuity. Upon the death of an annuity owner, an annuity can be subject to both federal estate and federal income taxes which results in a double taxation. This can result in a 40% to 70% loss of annuity value before the heirs can even receive it.

Tax Reduction

With respect to the recent tax revisions on social security tax, reduction is made possible by the realignment of municipal bonds and other investments into annuities. With qualified plans, such as IRA's, SEP's, Keogh's, the investor is reducing his pre-taxed income by contributing to the plans in the form of flexible (FPDA) annuities.

Tax Advantages

One pays no taxes while the money is compounding. The investor can also pay a lower tax on random withdrawals because he or she controls the tax year in which the withdrawals are made, and only pays taxes on the interest withdrawn. Tax deferral gives control over an important expense – the taxes. Any time the investor controls an expense, it can be minimize it. The longer any particular expense can be postponed, the greater the gain when compared to the gain that would be made with a fully taxable account.

Benefit gained from purchasing a Fixed Period annuity using certain tax-qualified money is that the income payments received automatically satisfy the Internal Revenue Service's (IRS) requirement that an individual withdraws ***Required Minimum Distributions from accounts set up under certain tax-qualified plans. The Required Minimum Distribution amounts generally must be***

withdrawn each year beginning after an individual reaches age 70½, and severe penalties are imposed if he or she fails to withdraw the full Required Minimum Distribution amount from a pre-tax plans and policies. A fixed period annuity may help ensure that an individual does not fail to satisfy the IRS's requirements.

An individual pays no taxes while the money is compounding. He can also pay a lower tax on random withdrawals because he controls the tax year in which the withdrawals are made, and only pays taxes on the interest withdrawn. Tax deferral gives him control over an important expense - his taxes. Any time he controls an expense, he can minimize it.

Tax-Deferred Advantage

To illustrate the increased earnings capacity of tax-deferred interest, compare it to fully taxable earnings. $25,000 at 6.0% will earn $1,500 of interest in a year. A 28% tax bracket means that approximately $420 of those earnings will be lost in taxes, leaving only $1,080 to compound the next year.

If these same earnings were tax-deferred, the full $1,500 would be available to earn even more interest. The longer one can postpone taxes, the greater the gain. A qualified legal reserve life insurance company is required to meet its contractual obligations to the investors. These reserves must be equal to the withdrawal value of the annuity policy. In addition to reserves, state law also requires certain levels of capital and surplus to further increase policyholder protection.

Legal reserve refers to the strict financial requirements that must be met by an insurance company to protect the money paid in by all policyholders.

Special Circumstances and Taxation

Avoiding taxes is one of those things that almost everyone truly enjoys. There are very few people who brag about paying taxes. The most attractive feature to most folks about an annuity is precisely that tax-deferred growth. And, indeed, as long as the money remains inside the annuity, the government will not tax any of the earnings.

Withdrawals and Taxation

Withdrawals from annuities are taxed in one of two ways, depending upon when the annuity was issued. Annuities issued prior to 8/14/82, were structured with FIFO accounting (first in, first out). Since principal was first in, it came out first, tax-free.

For annuities issued on 8/14/82 and thereafter, taxation changed to LIFO (last in, first out). Simply put, withdrawals are now taxable since interest is withdrawn first. Many customers will enjoy paying taxes only when interest is withdrawn, since most are now paying taxes on interest even if they do not withdraw it.

Withdrawals of earnings from a nonqualified annuity are fully taxable at ordinary income tax rates unless the annuity was purchased before August 14, 1982. Then the earnings are considered withdrawn first and are therefore subject to taxation. All withdrawals will be fully taxable as ordinary income until the account value reaches the initial amount invested. If this individual is under age 59 ½ when making the withdrawal, he or she may be assessed a 10% penalty on any taxable earnings.

Surrenders and Taxation
Loans are generally not taxable.

- A loan or distribution from a Modified Endowment Contract (MEC) causes ordinary income tax to the extent of any gain in the policy, plus a 10% penalty unless the policy owner is age 59 ½, disabled, or takes substantially equal periodic payments over life expectancy.
- A pledge or assignment of a MEC also triggers taxation (and possible penalty).
- Any surrender from a MEC is subject to income taxation on gain in the policy.
- Dividends received in cash are generally not taxable until they exceed basis.
- Partial surrenders and surrenders of additions are generally not taxable until exceed basis.
- Partial surrenders during the first 15 years of a policy may result in taxation under the forced-out gain rule.

Federal Income Taxation

The federal income tax treatment accorded annuities, governed by Section 72 of the Internal Revenue Code, has changed over the past 10-15 years. As a result, the specific income tax treatment may vary depending on when the annuity contract was purchased. In general, there is no current income taxation to the policy owner with respect to the interest credits applied to amounts invested in personally owned annuities. Taxation always occurs when a portion or all of the

cash value is withdrawn, when a loan is made against the cash value, when there is a partial or total surrender of the annuity, or when annuity liquidation begins.

The taxable amount equals the excess, if any, of the cash value over the cost basis of the annuity contract. An annuity's cost basis, which is recovered tax free, generally consists of the premiums paid into the contract. This is less any dividends that were not previously taxed. Amounts subject to taxation are taxable as ordinary income and are not eligible for capital gains treatment. An additional 10% tax may apply to taxable annuity payments unless the annuity payments:

- are made to an individual who is age 59 ½ or older;
- are comprised of a series of substantially equal payments over the lifetime of the annuitant or the joint lifetimes of the annuitant and designated beneficiary;
- are made on the account of the death or disability of the annuitant; or
- are attributable to investment in the contract prior to August 14, 1982.

Other exceptions to the 10% “premature” distributions tax also exist. Because of the complexity of IRC Section 72, a tax adviser should be consulted when needing answers to specific questions concerning the federal income taxation of annuities.

Federal Estate Tax

Individuals are subject to federal estate tax on the value of their taxable estate at the date of death, at a rate as high as 50% for 2002. Objectives in estate planning should include family security and minimizing estate taxes.

The consequences of federal generation skipping transfer taxes and state estate taxes should also be considered in estate planning. This generally includes insurance proceeds in which one held any incidents of ownership; IRAs and qualified plan proceeds; certain gifts; and any type of right to control property. Generally, the beneficiary’s cost basis of property received from an estate is its fair market value at the date of death. However, for traditional IRAs, qualified plans and annuities, the beneficiary takes the decedent's cost basis (and not the fair market value at the date of death).

Tax Advantages for Estate Planning

The Internal Revenue Code (“IRC”) provides opportunities for taxpayers inclined to donate property to charitable institutions. With careful estate planning, these opportunities can be combined in such a way that the donor will end up benefiting

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more than if certain types of property had been kept. With planning, the donor can be availed of a current income tax deduction or a reduction of future estate taxes, and, in addition, a large gift can be made free of any gift tax. These savings can be used to increase current income and also to insure that a donor's heirs will receive as much as they would have if the donor had kept the property.

What follows is a general overview of some techniques that can be used to combine the desire to benefit a charity while garnering significant tax advantages for the donor. It is not intended as a guide as to how to structure these transactions but merely as a general overview of how tax advantages can be combined to reward benevolence.

The law recognizes two types of giving: An inter-vivos gift is a gift made during the donor's lifetime. Gifts made at death in the donor's will are *testamentary gifts*. Both types of gifts can also be made by creating trusts, hence *inter-vivos trust* and *testamentary trust*. Use of a trust enables the donor to split the ownership from the enjoyment of the benefits of the property held by the trust.

There are a variety of reasons why one might want to do this. Often trusts are used to provide for someone who is not able to undertake the legal responsibilities of full ownership of the transferred property. In charitable giving, trusts are sometimes used to allow the donor to retain some benefit from the transferred property while still living. There are many advantages, and also some disadvantages, involved in giving property to entities that qualify as charities under the IRC.

Of particular interest to many taxpayers is the reduction of income taxes. There are certain requirements that must be met before the donor/taxpayer will be allowed to take the deduction: the income tax deduction is only available where the donee - the charity - qualifies as such under the IRC; the gift must be property (i.e., the value of time or services given to the charity cannot be deducted); the contribution must exceed the value of anything the donor receives from the charity in return (i.e., the deduction is limited to the amount by which the donor's gift exceeds whatever value the charity gave in return); and the gift must be paid in cash or property before the close of the tax year in question. Gifts of partial interests and gifts made in trust will be deductible only if they meet the strict requirements imposed by the IRC.

Estate Taxation of Annuities

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If the contract owner dies during the deferral period (prior to annuitization), the entire account value of the annuity is included in his or her gross estate for purposes of determining the estate tax. If the contract owner dies after annuitization has begun and payments continue to a beneficiary (under period certain or survivor annuity), then the present value of those future payments is included in the contract owner's gross estate. If the annuitization election is the life-only option, then there is no value for estate tax purposes, since payments cease at the contract owner's death.

Minimizing Taxes with Annuity

Favorable tax treatment is one of the main reasons for buying an annuity. Unlike most investments, an individual will not owe taxes at the end of the year simply because an annuity increases in value. The earnings on an annuity grow tax deferred until the policy owner is ready to take distributions. If an individual begins taking distributions from an annuity after retiring, moreover, it's possible that will put the owner in a lower tax bracket. Earnings may be taxed at a lower rate thus providing good news if an individual is in a fairly high tax bracket presently. In addition, of course, it is possible to control the timing and receipt of annuity income.

- If a withdrawal is made prior to age 59 1/2, the withdrawal may be subject to a 10% IRS penalty; and
- The money paid into an annuity (in the form of premiums) is not deductible on a tax return.

Split Annuity Taxation

An investment's return is what most people analyze each year. But what really counts is how much the individual holds on to after taxes. After all, that's what one gets to spend. If an individual is shopping around for CDs, he or she may want to look at an alternative idea that will let him or her keep more of what is earned. Suppose that this individual is considering a five-year jumbo CD.

The certificate's earnings will push provisional income over the government's threshold. The result is that more of the Social Security check will become taxable. The solution could be an immediate annuity that will pay an income for five years (five- year certain). Part of that income will be taxable, while the rest considered a tax-free return of the investment.

At the end of five years, the payments stop. To replace the funds one had put into the immediate annuity, he or she would invest in a five-year fixed annuity. Interest

earning on the fixed annuity are tax-deferred and not counted towards the government's threshold on taxation of Social Security income.

The result is that this individual would have one investment that is partially taxable and another that is tax-deferred, thus the provisional income should go down. With the right planning, one may possibly reduce it to the point that he or she would not have to pay income taxes on any of the Social Security benefits.

Additionally, a decline in one's adjusted gross income will lower the floor on medical expense deductions, and miscellaneous itemized deductions. When the five years are up, this individual could remove funds from the fixed annuity, pay the income tax, and purchase another immediate annuity or annuitize the fixed annuity for lifetime payments. Much of this strategy depends on one's current tax bracket, itemized deductions, exemptions, and income requirements.

Prescribed Annuities

Prescribed taxation may be available for annuities purchased with non-registered funds. ***Prescribed annuities are not subject to the accrual taxation rules where interest is taxed as earned*** (ie. with higher amounts in the early years and lower amounts in the later years). Instead, the total expected interest to be earned over the life of the entire contract is spread evenly over all payments. Single Life Annuities, Joint and Survivor Life Annuities, and Term Certain Annuities can all be prescribed. Taxation of prescribed annuities is on a calendar year basis - the taxpayer receives a tax slip for the interest portion of all payments received in a calendar year.

Prescribed taxation is generally more favorable than non-prescribed taxation, because the tax is averaged over the lifetime of the annuity providing an element of tax deferral. An exception to this rule is for Accelerated Annuities (which are based on shortened life expectancy), because prescribed taxation is based on normal life expectancy. In these cases, non-prescribed taxation may be more beneficial.

To qualify for "level" prescribed taxation within non-registered contracts, the following is a partial list of conditions that must all be met:

- The annuity must be purchased with non-registered funds,

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- The payments must not be guaranteed beyond the owner's 91st birthday (or the 91st birthday of the youngest annuitant for a joint and survivor Life Annuity),
- The payments must be level (indexing is not allowed),
- The owner and the person entitled to the payments (payee) must be the same and may not be a corporation,
- The payments must begin in the current or next calendar year.

Non-Prescribed Annuities

Non-prescribed annuities are taxed using accrual taxation and the income earned on the contract must be reported in the taxpayer’s income on each anniversary day of the policy. Taxation of non-prescribed annuities is on a policy year basis - the taxpayer receives a tax slip for the interest portion of all payments received in a policy year.

Since individuals report their income on a calendar year basis, the amount reported on an anniversary day is included in the individual’s income for the calendar year in which the anniversary day falls. In general, clients should consider the tax advantages of prescribed annuities over non-prescribed annuities. However, there are situations where non-prescribed annuities are appropriate for a client. These situations include clients who want:

- A payment guarantee past their 91st birthday,
- Payments indexed to help combat inflation,
- The annuity to be owned by a corporation (not an individual), or
- An Accelerated Annuity / Nursing Care Income Plan, in some cases.

Summary of Annuities and Taxation

When a person inherits an annuity, the embedded income-tax bill stays with the policy. Taxes will have to be paid on the lump sum received or on regular fixed payments, depending on the type of annuity. The original owner may well have been a retired senior in a much lower income-tax bracket than the heir. There are a variety of annuities available, including variable and fixed-rate annuities; some pay out immediately, while payment from others is deferred for a number of years.

While annuities pass to heirs or beneficiaries outside the probate process, they’re still considered part of the estate when figuring estate tax. So beneficiaries may have to pay estate tax even if they will not be getting the annuity payments for a

long time. For estate-planning purposes, a parent or grandparent may want to consider surrendering an annuity, an option on some products, or selling it in favor of a life-insurance policy.

Chapter 9
Annuity Marketing Resources for Financial Advisors

Annuity Leads

The Pursuit of CD Buyers
This market seems obvious in that conservative investors buy CDs and they would also buy fixed annuities or variable annuities with principal guarantees. However, this is a “back door” method of marketing or “bait and switch” marketing. With this method, an agent advertises attractively yielding CDs and then attempts to switch the callers to annuities. Some money can be made doing this, but it will not be easy. Can an agent be a big producer doing this? No.

The biggest producers are “front door” marketers. They do not attempt to bait people and then pull a switch. They advertise for annuities and then the people who call do not need to be switched. They make better prospects because they are calling for what interests them. The result is less time wasting calls, and the close percentage is higher. In the beginning of one's career, this CD method of marketing works and it gives an agent people to talk to. But no large producers use this method.

Locating CDs to Sell
There is no license required to sell CDs but there are regulations for advertising. Also, even though there is no license requirement, the only way to place these trades is through a broker dealer. So an agent will need a securities license to join a broker dealer. Then, the broker dealer will have a listing of CDs available or one can log onto a bank’s website and look at their CD inventory. They can also provide ads that meet regulations and a good disclosure document to provide the CD buyers. Of course, selling CDs (typically pay only a 1% commission but some prospects will not want annuities.

The Senior Market
An agent will make their largest sales to people over 60 as they are most attracted by the principal guarantee of most annuities and the tax aspect. They like to be conservative and annuities fit their desires. Additionally, seniors have more money than younger people and many already have annuities, which they may exchange for a new annuity. Because they already own annuities, there is no need to present something new. People tend to invest in items that are already familiar to them so selling a second, third or fourth annuity to one person is common.

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Existing Annuity Owners
Some mailing list companies claim to have lists of annuity owners. Often, they advertise in the classified section of industry magazines. Or, one can visit the library and look in Standard Research and Data Service, which is a list of virtually every list that exists. To find out more about marketing systems to meet existing annuity owners, check out the websites.

Or an agent can find an annuity agent that's retiring and offer to pay them 25% of annuity annuities the agent sells to their list. Check with www.agentmediacorp.com and they may be able to supply a list of agents in the area by age or estimated age by the initial date they were insurance licensed. Then just send a letter to them and call them.

Host-Beneficiary
Relationships Hosts are people who can bring in business. The beneficiary is the agent. Many financial planners think the only host-beneficiary relationships are with attorneys and CPAs. But the hosts are any person or organization that has existing relationships with the people an agent wants to meet--people over age 60.

Many hosts fit this description: Hospitals, Estate Attorneys, Elder Law Attorneys, Assisted Living Facilities, Retirement clubs and associations (e.g. the retired teachers association, the association of retired federal employees, the garden club, AARP local chapter, etc) Pharmacies, Home care agencies, the bus driver of the senior bus shuttle or at the senior center.

An agent can contact each of these possible hosts and tell them they help seniors to secure their financial future. They can give a talk to their senior clients. Have their business card distributed. Notify them of a public talk being given. Help them fulfill their mission

Direct Mail
Mentioned above is obtaining a list of annuity owners. Mail them an offer to receive a free booklet about “Annuity Owner Mistakes”. For direct mail to work, an agent must make a non-intimidating offer such as:

- Call a voice mail line for a free booklet;
- Call to reserve a seat at a seminar;
- Send back the form for a free-safety analysis of your annuity.

Annuity Seminars
These work great for the over 60 crowd because they have time to attend and they like to learn more about managing their money. And seminars are non-intimidating where they can remain anonymous. There are many annuity seminar systems on the market. Here's what to look for:

- Is there a clear process to fill up the room (filling the room is the most important aspect of a seminar)?
- Is there a process to close appointments right at the seminar?
- Is the system more than just some nice slides that discuss tax deferral (every senior who's not been asleep already knows about that)?
- Is there a need to feed the attendees (in a good system, feeding people is not necessary)?

An agent should be careful as many annuity marketing firms may provide a seminar system for free but then require them to write their annuity business with them. So an agent may save $1500 up front and then lose an extra ½% every time they write an annuity

Annuity Market Growth

Experts and trade analysts consider the annuity market to be on the threshold of experiencing huge and steep growth in the next decade. In the past, annuities have been found to be on a back seat to mutual funds since the middle class and lower middle class mass market did not embrace them. There were a lot of strict controls and risks involved with annuities. The opening up of variable annuities, equity indexed annuities and a large number of options of repayment schemes have done wonders to the annuities market

With the future climate for savings related to retirement enlarging, the potential of the annuities market is bright. The original driving force behind the evolution of annuities was a permanent income for life. The last 10 to 15 years this industry has seen changes with many options of annuitization opening up and competing with other financial instruments in the market.

This has been coupled with the fact that the annuity business has a diverse sales force, which includes independent agents, career life agents, stockbrokers and banks. This along with the thousands of websites with calculators and instant solutions of retirement planning with annuities, the market has grown.

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Independent agents have outdone the other sales forces in the fixed annuity market in most parts of US. Even though it is tough to put exact figures on this industry, due to inherent confidentialities involved with such private investments, the size of the market is extremely large and is about to touch the volume of normal life insurance business in US.

As per the last available official figures of 1994, ***according the Life Insurance Marketing and Research Association (LIMRA), independent life agents responded that 36% of the business in retirement was in fixed annuity market, which was the highest of any of the distribution systems*** at that time. A more recent report of 2006 by *Mintel* roughly states that approximately 75% of all variable annuity sales included a Guaranteed Minimum Withdrawal Benefit feature.

In this lucrative and promising market the best guide to annuities is always the agent. With time, they recognize the detailed calculations of annuities and its associated benefits. However, if they are into it for the first time, it might be beneficial to do some homework. Talking to annuity experts can always be helpful, but the most effective is a self-research and interacting with friends who have their money already invested in annuities

Annuity Marketing Options

An agent may be interested in annuity marketing and how it can help them make more money. How do people find out about the annuities that are offered for sale? Does the agent get in touch with them via phone? Does the agent have his or her own website? Do they use a lead generation service? All of these questions have a lot to do with annuity marketing. If a person is an agent and they do not know what annuity marketing is all about, they will run into down periods time and time again. In order to fight against this they should learn how they can use annuity marketing to their advantage.

One of the best annuity marketing options to look into is simple networking. With the way that technology is growing many people look over this way of annuity marketing. They think this trend has passed on, and they can only use the internet in order to market their services. But when it comes down to it annuity marketing through networking is still one of the best options to consider. Anytime an agent has the chance to network they should take advantage of it. This way they will be well on their way to having success on a regular basis.

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Another annuity marketing option is to use the internet to an agent's advantage. As mentioned above, this should not replace networking, but it can most definitely complement it nicely. One way to use the internet for annuity marketing is by purchasing leads from a generation company. This is marketing per say, but it can go a long way in helping the business.

Overall, annuity marketing is very important if one wants to make money on a consistent basis. This is something that all agents need to become familiar with. So if they sell annuities or want to get started, consider all of the annuity marketing options. There is a lot of money to be made in this industry. All one has to do is go out and get their share.

Indexed and Fixed Annuity Leads

There are indexed annuity and fixed annuity leads offered with a great variety of options. Annuity leads are also in high demand, but are difficult to generate. Just as long term care and disability leads they tend to more heavily concentrated in senior market. Some sell annuity leads only to agents buying the company's life insurance leads.

Some companies spend over a quarter million marketing dollars each month to generate volume of quality annuity, as well as LTC and disability insurance leads. They use internet as wells as conventional marketing methods, targeting senior demographics to generate sufficient volume of quality prospects interested in annuity, disability and LTC leads.

Leads contain information to enable agents to provide prospects with a quote. Once information is provided and prospect's interest is confirmed the lead is being instantly matched with profiles of active agents on our network, with a choice of quotes from most respected carriers and financial entities offering annuity business in their state.

Annuity leads are sold at most competitive rates compare to other major leads vendors. Limit intake of any leads on daily, weekly, monthly basis, as well as territory by; selected zip codes, radius around a zip code at no additional charges.

An agent can login any time and modify their selection of filters and other criteria online. They can also login and modify their profile and criteria selection any time.

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Annuity Leads Generation

An insurance agent knows how important it can be to generate a good number of annuity leads on a regular basis. After all, annuity lead generation is what will keep them going day in and day out. As long as they are getting a large number of annuity leads they will always have something to do. And of course the more leads they have the more money they are going to make in the long run.

Annuity leads generation is not as hard as it once was. In the past one of the only ways to take advantage of annuity leads generation was to call people on the phone all day long. Of course this is still a good way to generate leads, but it is not the only option. Annuity lead generation can also be done online as well. An agent can either do this on his or her own, or hire a company to work for them. Either way, they will get the leads they need in order to be a success.

Overall, annuity leads generation is done in a number of different ways. After an agent finds a system that works for them, they should stay with it. This way they will always have leads to work on; even if things do start to slow down

Annuity Leads Assistance

There are companies online that assist annuity buyers from all over the United States in finding the best annuity to fit their personalized needs. Some are looking for seasoned agents who possess impeccable track records for service and meeting clients' needs and who also possess a deep knowledge of annuity and other investment products.

An agent should look for a premier web address for annuity information. They are at the top of every major search engine and consistently advertise on other websites and in various offline media outlets. People who visit their websites are actively looking into purchasing an annuity.

A lot of the websites are growing fast and currently have openings for qualified agents throughout the United States. They put the clients in touch with one agent in their area. Like other companies, they do not sell prospect information to lead brokers, who in turn resell the lead to dozens of annuity lead retailers. They respect their clients and therefore their information is only shared with one agent. This is also beneficial to agents because they are getting a lead that is fresh, qualified and responsive.

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An agent should look for one who has a reputation to protect, so the company would be very selective with whom they take on to represent their company. Trust, ethics, knowledge, and putting the client first should be most important. This is what the company should be about. If an agent fits this description and would like to be put in touch with quality prospects actively seeking to purchase annuities in their area, they can fill out the form provided on the website for an interview.

In addition to referrals, some websites also have a highly attended, critically acclaimed seminar system that can help an agent attract and educate quality prospects.

Marketing Tools and Illustrations

One agent shared a great idea. His door opener is, "Do you want to pay Uncle Sam or would you rather pay yourself?" Here's how his idea works:

Many seniors have set aside some money for a "rainy day" that they hope they will never have to use. Most of this money is in safe, fixed, taxable accounts such as bank certificates of deposit. Let us assume the following situation: Reed Johnson, age 70, has a $100,000 CD earning 4.00% interest. Since Reed is in a 25% tax bracket, he pays $1,000 in federal income taxes, or "Uncle Sam," each year on this interest.

"If you could pay yourself that $1,000 per year, instead of Uncle Sam, and not sacrifice the growth you would have on the CD, would you do it?" The following illustration shows the numbers and summarizes the products used in this concept.

The agent divided the $100,000 into two products:

> $8,140 into AIG American General's SPIA which is guaranteed to pay $1,000 per year for 10 years
> $91,860 into Great American's American Legend II fixed indexed annuity with 100% allocated to the point-to-point strategy with a 100% participation rate and a 9% cap.

The Flexible Income Stream illustration shows the guaranteed values (worst case) after 10 years at $10,000 income plus $123,452 accumulation. That compares well to the $134,392 balance in the CD after 10 years.

The agent used a 4.00% "Illustrated Rate" on the Flexible Income Stream's report for several reasons:

- It has a reasonable probability of being achievable.
- At 4% interest, the annuity will have a higher value after 10 years than the CD would have had.
- Insurance departments are taking a suspicious look at illustrations right now – it is best to be conservative.
- Customers who buy annuities are conservative – they appreciate agents who use conservative, realistic, projections.
- This product includes a guaranteed lifetime income rider – even if the product returns 0% per year, the customer has the option of taking a $10,288 annual income for the rest of his life. This may be an attractive option in 10 years, at age 80, if this customer is in good health.

The agent backed up the Flexible Income Stream illustration with a SPIA illustration from AIG American General and two illustrations by Great American. The Great American Illustration system allowed the agent to create two hypothetical historical illustrations based on two dates:

- A "low" scenario using January 1, 1973, where Watergate, the Oil Embargo, and the Iran Hostage Crisis all came into play
- A "high" scenario using January 1, 1988 where the market recovered from the drop on "Black Monday," October 19, 1987 and the technology boom of the 1990s.

Two or more illustrations that show extreme lows and extreme highs can help the customer understand that the future is uncertain and there is no real way to "project" what an indexed product will achieve in the future. It also prepares them to expect some years with a zero percent interest rate in the future. Always highlight the guarantees as a "worst case" because it is entirely possible that is all that an indexed product will return.

The graph created by Great American's software of the 3% Monthly Sum strategy based on a historical January 1, 1973 date rather prove this point. During this 10 year period, this strategy would have returned a paltry .43% hypothetical annual interest rate – more than $20,000 less than the guaranteed minimum surrender value. Their software is an invaluable tool for agents to compare several interest crediting strategies in a realistic, straight-forward, way.

In summary, ***this sale qualifies as a "suitable sale" for the following reasons***:

- ***The client's timeframe for using the money in the certificate of deposit is 10 or more years in the future***
- The client wants to reduce his income tax liability by $1,000 per year
- The guaranteed values are on par with the values of the certificate of deposit
- The liquidity in the annuity is acceptable to the client – 10% free withdrawal, plus a 7 year surrender charge period
- The point-to-point index strategy was explained and understood by the client
- The client expects to receive about a 4% future rate of return from this annuity, with the chance of receiving something slightly higher
- The client's money is in a safe place, with a guaranteed minimum interest rate
- The annuity product has the option of being converted to a guaranteed lifetime income
- The client receives a $1,000 per year income payment instead of a $1,000 per year tax bill

Exhibit 1: Low Interest Scenario
Hypothetical point-to-point strategy, January 1, 1973, 100% participation rate, 9.00% cap, 0% spread.

Major point is an indexed annuity is designed to protect the policyholder against major drops in the market index. Annuities protect the policyholder against a loss of principal. In 1973 the market dropped by about 20% followed by another drop of about 30% in 1974. In those years a 0% interest rate would have been a blessing. Hypothetical average rate of return for this 10 year period: 4.08%.

Exhibit 2: High Interest Rate Scenario
Hypothetical point-to-point strategy, January 1, 1988, 100% participation rate, 9.00% cap, 0% spread.

Major point of this is because of the "cap" an indexed annuity will not capture the high returns of an extremely aggressive market; however, during these periods, they are designed to deliver a higher than average interest rate. This was one of those rare time periods where the index returned only two zero percent interest rates in a ten year period. Hypothetical average rate of return for this 10 year period: 6.10%.

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Guaranteed Income Riders Confusion

At one company, one of their support staff received a call from an agent who was upset because he wanted to illustrate an 8% return using Stretch IRA software and it allowed him to show a maximum of only 6%. He said that “the policy guarantees an 8% lifetime interest rate” and he wanted to illustrate 8% to his customer. Unfortunately, this is a common question when indexed annuities with guaranteed income riders work are misunderstood.

First of all, selecting an income rider is not a suitable option for someone who wants a Stretch IRA because the income produced by the rider will very likely deplete most of their indexed account if they live until age 90 or more. Also, a person elects a Stretch IRA because they want to leave as much money to their heirs as possible. The income rider defeats this purpose because over 10 years, the difference in indexed accumulation value between electing the guaranteed income rider is substantial; at age 70, it can be as much as $8,000 per $100,000 premium.

The indexed account and the guaranteed lifetime income account are different accounts, with different purposes. The indexed account is an *accumulation* account; it is money the customer can touch. The income account is just that – an account from which the guaranteed lifetime *income* is formulated. The account holder cannot touch this money; it does not exist in any tangible form.

Here’s the math. After 10 years, the *income account* growing at the 8% guaranteed interest rate accumulates to $215,892 which will produce a $17,271 guaranteed lifetime income. The $17,271 annual income is impressive, but what is the $215,892? Can the account holder withdraw this money? No. It is simply a number used to calculate the $17,271 annual lifetime income. What happens if the account holder decides not to exercise the lifetime income option? It all vanishes.

The $8,000 cost for this rider [calculated by doing an illustration with and without the rider and comparing the difference] is completely wasted. In retrospect, agents should not even talk about this phantom guaranteed 8% interest rate or the income account. Throw around this “8% guaranteed interest rate” and this will be all customers will remember. It leads to false customer expectations, unhappy clients, and opens the doors for lawyers.

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To illustrate the point, let's look at two hypothetical scenarios on a $100,000 deposit into a Fixed Indexed Annuity for a 70 year-old man held for 10 years, after which the guaranteed lifetime income option is exercised

- **Scenario One --** The index does poorly and account earns only the guaranteed minimum surrender value of $128,208. In this case, the guaranteed lifetime income is a blessing because the account holder will be able to withdraw $17,271 each year for the rest of his life. Let us assume that he lives until age 92, about six years beyond normal life expectancy. The $17,271 annual withdrawal will deplete the policy by about age 88, so there will be no remaining cash value at death. The average rate of return for this scenario is 4.90%. If the policy holder dies at age 86, which is his normal life expectancy, his rate of return will be only 1.64% This isn't too bad for a worse-case scenario.

  Once the guaranteed income begins, this income is withdrawn from the indexed account, not from the "guaranteed income account," which no longer exists.

- **Scenario Two --** A hypothetical historical point-to-point, 10% cap, 0% spread, 100% participation rate product issued on January 1, 1990 grows to $190,152 after 10 years, an impressive 6.64% return. Based on the income available under the guaranteed income option, the customer begins to withdraw $17,271 each year. The hypothetical historical return in 2000, 2001, and 2002 for this product was 0%. Withdrawing $17,271 per year reduces the indexed value to $138,338 after three year of these guaranteed withdrawals.

Even if the indexed annuity receives 10% per year every year thereafter, the indexed value will decrease quickly because the withdrawal is higher than the interest rate. In the unlikely event that the policy earns 10% every year for the next 8 consecutive years, and death occurs at age 92, the indexed account will have been reduced to $68,212, providing an average rate of return of 6.04%. If the policy holder dies at age 86, which is closer to his normal life expectancy, his rate of return would be about 5.29%.

What happened to the "8% guaranteed interest rate?" It never existed. A hypothetical historical scenario could not be found where it is possible for a policy holder to achieve anything close to an 8% of return from a fixed indexed annuity

contract from a guaranteed income rider on a hypothetical basis, let alone on a guaranteed basis.

Guaranteed lifetime income riders are not bad. In fact, just the opposite is true. Go back to the fundamental reasons annuities exist:

- To provide safety
- To provide predictable, steady, guaranteed, lifetime income

A fixed indexed annuity with an income rider is an ideal vehicle to plug a specific income gap in a prospective client's retirement income stream. As shown above, however, the agent should not promise both income and a sizable cash inheritance after death. Generally, income riders provide either high guaranteed income or safe cash accumulation; they rarely provide both.

Annuities are ideal financial tools when they are used in ways that meet the customer's needs. This happens only when agents understand what annuities can do – and what they cannot do.

Considering Legal Matters

A senior officer of one of America's largest insurance companies said, "Five years ago we had five compliance attorneys; today we have one hundred and twenty five." Annuity compliance has become a hot topic. Do a Google search and learn:

In 2006 the National Association of Insurance Commissioners released Model 275 which has been adopted by most states. Here are the main points:

Duties of the Insurance Agent and Agency

- An insurance agent shall have reasonable grounds for believing that any recommendation to a consumer is suitable on the basis of the facts disclosed by the consumer as to their investments, other insurance products and their financial needs.
- Before executing a purchase of an annuity to a consumer, an insurance agent must make reasonable efforts to obtain information concerning the consumer's financial status, tax status and investment objectives.
- A system to comply with this regulation must be established that includes:
- Maintaining written procedures.

- Conducting periodic reviews of records designed to detect and prevent violations of this regulation.
- An agent or agency must take appropriate corrective action for any consumer harmed by a violation of this regulation.
- An agent or agency must keep records of information collected in making recommendations to consumers for a minimum of three years after the transaction is completed by the insurer.

In short, agents, marketing companies, and insurance companies must be able prove that each annuity sale is made with the consumer's needs in mind, not because the annuity sold pays the highest commission.

Minnesota Attorney General Lori Swanson, perhaps the most aggressive regulator in the country, has sued the four largest insurance companies who sell fixed indexed annuities. On February 7, 2008, she released a press release announcing a settlement with American Equity. The other companies are still fighting – hence the need to feed more lawyers.

Texas lawyer John R. Fahy has published a 15 page report that outlines the massive legal exposure insurance companies face under Texas' version of NAIC Model 275 and FINRA's new Rule 2821. His arguments are convincing, and he is not alone in his beliefs, which is why the company I referenced above hired 120 new lawyers.

How can agents, marketing companies, and insurance carriers protect themselves from this threat? Most companies have tightened up their suitability disclosures taken during the application process, but this protection is limited unless the company can prove the information on this form was asked by the agent before recommending a particular annuity product. The following plan of action could be a possible option.

- Create a system where agents must ask questions to consumers about (to quote FINRA 2821) their "Age; Annual Income; Financial Situation and Needs; Investment experience; Investment objectives; Intended use of the annuity; time horizon; Existing assets (including investment and life insurance holdings); Liquidity needs; Liquid net worth; Risk Tolerance; Tax status; and Such other information reasonably used or considered in recommending annuities to customers."

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- Store the above information in a location accessible to the agent, his or her marketing company, and the insurance company for at least as long as the surrender period of the recommended annuity policy.
- Document that the data gathered was used to determine that the annuity sold satisfied a direct, quantifiable need for the consumer.
- Require agents to attach a copy of all sales materials, presentations, and illustrations used in making the sale — including scanned copies of yellow legal pad presentations.
- Require the agent to provide a written summary of why the annuity satisfies the consumer's need, and why it will better meet the objectives than the present source of funds.
- Supervise agents and enforce the above for *every* annuity sale.

These procedures are less costly than hiring a $300 per-hour lawyer. They are certainly less expensive to insurers than paying fines of $250,000 to $2,500,000 to insurance regulators. How expensive is bad press? How much money does an agent lose when he or she is suspended from selling for six or more months?

Most successful retirement professionals are already adhering to the above procedures because they know that these practices create more sales than they lose. There is no better defense against litigation than a well-trained, ethical, sales force that is armed with the proper tools.

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Chapter 10
Annuity Suitability Requirements

The concept of "suitability" as it applies to insurance based or insurance-derived products, particularly annuities, has increasingly moved to the forefront of financial product litigation over the last few years. It is imperative for the insurer, the producer and the agency to clearly understand the evolution of suitability, its applicability, and the potential dimensions of liability.

The rise in suitability claims, and regulatory scrutiny of suitability of annuity products for customers, should serve as a signal to be cautious when selling and advising customers regarding these financial products.

There are three things that a financial professional must put high priority on. These three things are:

- the concept of suitability and its evolution to include certain insurance-based or insurance-derived products;
- the dimensions of liability that attach to such recommendations;
- its applicability to particular insurance-based and insurance-derived products, such as annuities, that financial professionals recommend and sell to their customers.

Insurer Suitability Requirements

Suitability is a determination that based upon a customer's particular risk profile, other securities holdings, financial situation, investment objectives, and investment experience, that a financial product is appropriate for that customer. This necessarily requires an individual case by case, and product by product, determination.

The suitability determination by those selling or advising customers concerning certain insurance-based or insurance derived products does not make the financial professional a guarantor of a product's performance. Instead, it is essentially a determination that at the point of sale, and at the point of any required periodic portfolio review, the product is consistent with the customer's risk tolerance, financial objectives, and financial situation.

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Ensure Issuance for Suitable Transaction
At this point, the Suitability in Annuity Transactions Model Regulation 275 is the main formal NAIC document with suitability standards for insurance products. It has not been adopted by all states, and only adopted in modified form in others.

Establish a Supervision System
Investment advisers that are registered and regulated by either the U.S. Securities and Exchange Commission (SEC) or states, depending upon various factors, are required to provide only suitable investment advice and recommendations. Investment advisers' suitability requirement springs from their fiduciary duty to clients, and the fact that they are subject to the Investment Advisers Act of 1940 (Advisers Act) antifraud provisions, rather than black letter rule. Investment advisers' suitability requirement is basically the same as that for broker-dealers, in that investment advisers must only recommend securities investments to a customer that they determine are appropriate in light of the customer's financial objectives, investment experience and financial situation.

Because an artificial inequality began developing among the various products from a regulatory point of view, securities and insurance regulators have attempted to harmonize suitability rules among their regulated products. Regulators acknowledge the problems with differing suitability requirements but differing suitability rules still apply to the products.

Producers must keep a record of any annuity recommendations they've made for a period between four and 10 years, depending on the state. Insurers must periodically review their producer's records, provide product-specific training, and require a minimum four hour training course on annuities in general.

Establish Standards for Validating Producer Training
Producer education and training plays a key role in promoting consumer confidence in the fixed annuity industry. The producer typically works with an Independent Marketing Organization ("IMO"). The IMO assists the producer with marketing, training, and case design. The IMO will earn a percentage of the commission generated when the producer completes a sale.

Many producers that sell fixed indexed annuities also maintain active securities licenses. The purpose of education and training is to ensure that producers maintain the knowledge and skills necessary to make suitable and appropriate

recommendations of fixed annuities or fixed indexed annuities by attaining and maintaining an adequate level of knowledge and skill about:

- The state laws governing sales of the sale of annuities;
- Insurer requirements for submitting, processing, delivering, and servicing customer policies,
- Applying that knowledge and skill when making the recommendation of a fixed annuity.

An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has adequate knowledge of the product to recommend the annuity and the insurance producer is in compliance with the insurer's standards for product training.

Establish Procedures of Unsuitable Transactions
It is of high priority that the agent understand the liability that lurks when making an incorrect determination as to the type of product they are recommending and/or selling, and its corresponding suitability rules.

Specific Product Training
Generally the term "security" encompasses those financial instruments traditionally understood to be a security, such as stocks, bonds, debentures, securities options, notes, and certain other specifically enumerated securities instruments. Section 2(a)(1)'s definition of a "security" also includes what essentially has become the catch-all category of "investment contracts."

Reporting
Record keeping of the sales process may be a cumbersome and time consuming part of the producer's job but it is vitally necessary. Agents and producers build trusted relationships with their clients by providing comparison reports that demonstrate due diligence done on the client's behalf. These reports assist the financial professional in explaining what annuity features to show how the product is a suitable choice based on the client's unique needs. Reports can be generated for sales record keeping purposes to safe guard client information and information on the product being recommended.

Monitor FINRA Information
When registered broker-dealers are members of FINRA they are bound by NASD Conduct Rule 2310. This prohibits a broker-dealer and its associated registered persons from recommending securities to a customer unless the broker has reasonable grounds to believe that the securities are suitable for the customer's financial situation and

needs. Although FINRA is currently consolidating the NASD and NYSE rule books, the new rulebook will most certainly contain a suitability rule.

Compliance Mitigation
With the ever changing landscape of compliance issues surrounding annuity sales, replacements and exchanges – it's more important than ever to have the best way possible to mitigate compliance issues. When agents ”replace” or “roll” their current book of business every 7 years, they create a potential for a huge liability. Consequently, there should be a proactive solution that protects clients while satisfying reps in need of the recurring revenue.

The possibility of investor complaints due to poor management of client assets or unnecessary contract replacements in an effort to generate commissions has gone up and is likely to continue. Again, an ideal solution should address this issue before a potential problem exists.

Responsibilities of Insurer for a Suitability Violation

The consequences for violating the suitability rules can be severe, depending on the egregiousness of the conduct. NASD Rule 8310 states that FINRA members can be subject to FINRA disciplinary proceedings, and among other things, incur fines, suspensions or a bar from association with any member firm, revocation of registration, and be ordered to pay restitution.

Where the conduct rises to the level of fraud, the SEC may seek similar sanctions including but not limited to, civil penalties, an injunction in a civil action or cease and desist in an administrative proceeding, suspensions or a bar from the industry and revocation of registration for regulated persons, and disgorgement of ill-gotten gains.

In those states where an annuity product is classified as a security, similar sanctions may also be sought by state securities regulators. With respect to civil litigation, liability for the sale of unsuitable life insurance policies or annuities can run the gamut of creative plaintiff counsels' imagination. In states where there are applicable insurance or securities suitability requirements (whether limited to seniors or not), there may be rescission, consequential and/or punitive damages, and plaintiff's attorney's fees and costs.

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Corrective Action for Consumer Harmed by a Violation
Ensure producer and general or independent agency takes corrective action. In most of these cases, plaintiffs will also allege fraud which also could entitle them to punitive damages. In states that have elder abuse statutes, plaintiffs also may try to allege that the sale of an unsuitable insurance policy or annuity was a form of elder abuse, opening the door to statutory consequential and punitive damages, as well attorney's fees and costs. In addition, depending on whether plaintiff can allege an institutionalized marketing of unsuitable insurance policies or annuities, there is also exposure to class action lawsuits.

Considering Penalties
Penalties may be modified or waived if corrective action is taken promptly after discovery of a violation

Producer Suitability Requirements

It is important to obtain required suitability information. ***New suitability requirements state that the producer must have "reasonable grounds" to believe that the annuity recommendation is suitable based on 12 areas of "suitability information" disclosed by the consumer.***

A suitable annuity sale cannot simply be defined by any single criterion (such as age), or even by a variety of equally weighed factors. A person over age 65 may be able to buy a high speed sports car but more importantly he or she should be concerned about its safety features such as its crash rating and airbag features. Suitability is the process of identifying the client's needs, objectives and lifestyle requirements. Each of these items must be weighed against the other, balancing against each other according to their needs.

- *Age*
  An individual's age has everything to do with matching an annuity to his or her needs. If the individual is younger the style of annuity investing will be different that if he or she is 50 -60.

- *Annual Income*
  The individual's source(s) of annual income to continually live today and in the future is essential to evaluate in the annuity investing process. The income and savings situation of the client is extremely important when determining liquidity needs down the road.

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- *Financial Situation and Needs*
  The two cornerstones upon which those laws were built are investor protection, and protection of the integrity of the U.S. securities markets. Imposing a "suitability" requirement upon financial professionals who recommend securities products was a logical component of the overall scheme to protect investors and the markets. And the financial professional must accurately evaluate the financial situation and need of the client.

- *Financial Experience*
  The financial experience of the individual is important because it will be a determining factor is future investing options and the risk tolerance he or she will be able to sustain

- *Financial Objectives*
  Another point which is of great importance is what the future financial objectives are for the individual. If he or she wants get high returns in a short amount of time then aggressive investing will be the way to go. So if the individual can determine specific goals, the agent's job is much easier.

- *Intended Use of Annuity*
  81% of non-qualified annuity owners said that they intend to use the savings for retirement income. Retirement is mentioned as a primary use for annuity savings by those who are under 54 (82%). Twelve percent (12%) say that they plan to use their annuity savings to live on or be financially independent. But those who are age 64 or older say they intend to use their savings as an emergency fund in the case of catastrophic illness or nursing home care.

- *Financial Time Horizon*
  A time horizon, also known as a planning horizon, is a fixed point of time in the future at which point certain processes will be evaluated or assumed to end. It is necessary in an accounting, finance or risk management regime to assign such a fixed horizon time so that alternatives can be evaluated for performance over the same period of time. A time horizon is a physical impossibility in the real world.

  Although short term horizons such as end of day, end of week, end of month matter in accounting, generally it is mere summing-up and the

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simplest mark to market processes that take place at these short term horizons.

- *Existing Assets*
  When an individual is retired or getting ready to retire and has existing assets in excess of $100,000 set aside that is not being used or needed for income, an Annuity with Long-Term Care benefits is a possible option that has grown in popularity since the enactment of the Pension Protection Act on January 1st, 2010.

- *Liquidity Assets*
  Since annuities are not designed to be effective short-term investments, if the individual does not have sufficient liquidity to maintain a decent life style after purchasing an annuity, then probably an annuity is not suitable. If it appears that the client may need or want the funds that are invested in the annuity in the near future, then other types of investments or products should be used instead of an annuity.

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