UNDERWRITERS MARKETING SERVICE

FORUM

Key to Understanding Annuities

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CHAPTER 1

INTRODUCTION TO THE WORLD OF ANNUITIES

SO JUST WHAT IS AN ANNUITY?

Defining an "Annuity" is easy!

"An Annuity is a specified income payable at stated intervals for a fixed or a contingent period, often for the recipient's life, in consideration of a stipulated premium paid either in prior installment payments or in a single payment."

An annuity is basically a sum of money (accumulated funds) that has accumulated for the purpose of income payable annually or at other regular intervals to a designated individual. The actual sum of money is based upon a contractual relationship between the person covered (the contract owner) by the annuity and the insurance company (insurer) through which the investment is made.

In other words, annuities are tax-deferred savings that are predominantly used for retirement purposes. The main advantage of annuities is their tax-deferred feature, which allows an annuity owner to accumulate more money as compared to fully-taxed investments. This is one of the main reasons many people choose tax-deferred annuities as the foundation of an overall financial/retirement plan. However…

…Understanding an "Annuity" is quite a different matter!

An annuity's basic purpose is to provide a series of payments over a period of time. Usually this period of time is over the lifetime of the annuitant named in the annuity contract. This is a unique feature and is not found in any other investment or accumulation vehicle. It provides a stream of income that the annuitant cannot outlive, no matter how long that is. This lifetime guarantee of income is also unique in

that it promises to continue payments even after all of the annuitant's accumulated contributions and earnings are used up.

Some believe that annuities are a relatively new product as they have gained popularity throughout the years. However, they have been available for hundreds of years—several hundred, as a matter of fact, in other countries—though certain varieties, like the fixed indexed annuity, were first introduced in this country only 20 years ago as an alternative to mutual funds.

At one time banks were allowed to sell annuities and often issued their annuity products. In the early 1900's, individual state legislation made it illegal for banks to enter into annuity contracts unless an insurance company issued the product, which set the guidelines still in effect today. To allow banks to participate in the annuity market, select employees are picked to get insurance licenses.

WHERE IT ALL STARTS

A client investing in an annuity must complete an application. Once the application has been submitted to the insurer, the contract owner receives the contract, which contains a summary of the application, the rate of expected return on the investment(s) and type(s) of investments selected. Though annuities are primarily purchased to fund retirement, they are also used for any number of other reasons such as to fund higher education expenses, fund insurance settlements, business ventures, and charitable giving.

Even though annuities are sold only through the insurance industry (i.e., insurance agencies, brokerage firms, investment advisors, financial planners, banks, savings and loans institutions), they have nothing to do with life insurance or insurance coverage. Guarantees are dependent upon the type of annuity purchased, as you will soon see.

TERMINOLOGY USED IN REGARD TO ANNUITIES

The key to understanding annuities is understanding the verbiage surrounding the product. After all, if you don't really know what an "accumulation unit" is as we discuss it, your key will not open the door. So make sure you are familiar with all of these terms so you won't be locked out.

Account Value — The sum of the value of the Basic Interest Strategy, the value of all Fixed Term Strategies, the value of all Indexed Strategies, and the outstanding balance of any Annually Declared (fixed) policy loans.

Accumulated Interest — Interest earnings that have accumulated inside an annuity contract and have not yet been withdrawn.

Accumulation Period — The interval of time usually from the contract's date of issue to the annuity date or surrender of the contract.

Accumulation Unit — A measure of your ownership interest in a subaccount the prior to the annuity date or surrender of the contract. The value of the unit reflects the investment experience similar to that of a share owned in a mutual fund.

Accumulation Value — The total current value of a fixed annuity which includes all of the premium payments made plus accumulated interest earnings to date, less any fees or previous withdrawals, but before the application or any surrender charges.

Annual Point-to-Point — An index annuity crediting method that measures the percentage change in the underlying index value between two dates, the beginning and the end of the annuity contract year.

Annual Reset — An indexing method used with fixed indexed annuities where the index value is reset and interest earnings, if any, are credited at the end of each contract year, creating a new index value starting point for the coming year. Interest earnings are locked in and future decreases in the index value will not affect the interest already earned.

Annuitant — The person on whose life is used to determine the length of the annuity payments and upon who death the benefits are calculated.

Annuitization — The process of converting an annuity contract's value into a guaranteed income stream represented by periodic payments made over a specified period of time, commonly for life.

Annuity — An insurance product under state law that is individually solicited, whether the product is classified as an individual or group annuity.

Annuity Date — The date elected by the owner as when annuity payments will begin.

Annuity Payment — One of a number of choices one may makes to receive annuity payments. Payments generated from the fixed annuity option remain constant and do not change over time. Payments from the variable annuity option that are based on the performance of the underlying subaccounts do change over time.

Annuity Unit — The measurement used in determining the amount of any variable annuity payment. The value of an annuity unit for each subaccount will depend upon the assumed investment rate and the investment experience of that subaccount, and will vary in dollar amount.

Averaging — An index annuity crediting method that uses the average (usually monthly or daily) of an index's value to determine interest credits rather than a point-to-point method that records the index value change between two specified dates.

Basis Point — A unit of measure for interest rates where one basis point is equal to 1/100th of 1 percent, or 0.01 percent (1%, or 0.01%).

Beneficiary — The person or entity designated as the recipient of the death benefit upon the death of the annuitant.

Bonus Annuity — A type of annuity where the insurance company adds a bonus amount to your annuity, usually a set percentage of the amount you put in when you buy or add money to your contract.

Cap — An upper limit, used with some indexed annuity crediting methodologies, on the index-linked interest rate that is applied to the annuity. The cap is the maximum rate of interest the annuity can earn during the index term.

Cash Compensation — Any discount, concession, fee, service fee, commission, sales charge, loan, override, or cash benefit received by a producer in connection with the recommendation or sale of an annuity from an insurer, intermediary, or directly from the consumer.

Cash Refund — A type of immediate annuity payout option where the insurance company guarantees that the total payout will not be less than the amount paid to purchase the annuity. If the annuitant dies before receiving payments that equal the purchase price, the difference is paid to the named beneficiaries in a lump sum.

Cash Value — The account value less any withdrawals and any surrender charges that apply.

CD-type Annuity — Also referred to as a multi-year guarantee annuity, it is a type of fixed annuity where the interest rate is guaranteed in advance for a set number of years.

Certificate of Deposit (CD) — A savings certificate issued by a bank or credit union that guarantees a set interest rate for a predefined period of time, typically three months to five years.

Consumer Profile Information — Information that is reasonably appropriate to determine whether a recommendation addresses the consumer's financial situation, insurance needs and financial objectives.

Contingent Annuitant — The person named to become the annuitant on the annuitant's death prior to the annuity date.

Contract Anniversary — The annual anniversary of the annuity contract issue date.

Contract Date — The date on which the contract was issued.

Contract Year — The 12-month period following the date of issue of the contract and each 12-month period thereafter. In certificates issued under group contracts, these periods are known as "Certificate Years".

Cost Basis — The collective total of your initial premium deposit, and any subsequent premium deposits, paid to purchase a nonqualified annuity.

Current Rate — The interest rate that is credited to the fixed or guaranteed account. The current rate is established by the issuing company and may changes with interest rates in general.

Daily Averaging — An index annuity interest crediting method that is calculated by comparing the underlying index value on the first day of the contract year to the daily average of that same index at the end of the year. The daily average index value equals the sum of the daily index values recorded each trading day over the course of the preceding contract year, divided by the number of trading days. At the end of each annual index term, the percentage change between the index starting value and the index daily average value is used in determining the amount of interest that is credited to the annuity, if any.

Death Benefit — The benefit paid to the beneficiary in accordance with the provisions in the contract. The actual amount payable at death may be decreased by loans or withdrawals, or increased by additional insurance benefits.

Deferred Annuity — Any annuity that has not yet begun to make income payments. Deferred annuities are purchased with the intent of letting the money grow inside the contract for a period of time, before annuitizing the policy and activating an income stream. A deferred annuity can be either fixed or variable.

Deferred Income Annuity — A product designed to provide a guaranteed lifetime income stream beginning at a predetermined future date, from a few years and up to 40 years in some cases. Usually, the income payout will be significantly higher than with an immediate annuity. (Can also be referred to as a longevity annuity)

Exclusion Ratio — It is that portion of an annuity income payment, represented as a percentage, which is considered a return of premium (cost basis) and therefore not taxed.

FDIC — The Federal Deposit Insurance Corporation is a federal government corporation that provides deposit insurance guaranteeing the safety of a depositor's accounts in member banks up to certain dollar limits.

FINRA — Financial Industry Regulatory Authority.

First Year Yield — The guaranteed first year yield, including bonuses if applicable.

Fixed Account Rate — The current interest rate applied to premium that is allocated to the fixed account. Typically, this interest rate is adjusted annually by the insurance company after contract issue.

Fixed Annuity — A type of annuity where money earns interest at rates set by the insurance company or as spelled out in the annuity contract. The insurance company guarantees both interest earnings and principal.

Fixed Indexed Annuity — A type of fixed annuity that uses a stock market index as the basis for determining what the interest credits will be.

Flexible Premium — A kind of annuity contract that allows periodic additional premium deposits. After establishing the annuity with an initial deposit, further premium can be added to the policy at later dates.

Free Look Provision — The period under which the contract can be cancelled and treated as void from the contract date.

Guarantee Period — A period of time during which the company will credit a stated rate of interest. The guarantee period is usually one year.

Guarantee Period Annual Yield — The guaranteed annual yield, including bonuses if applicable, for the initial guarantee period term, up to the first penalty free full withdrawal window.

Guaranteed Account or Fixed Account — That subaccount which is not part of the separate account and is part of the general account of the issuing company. This account is segregated from other assets of the company and earns a guaranteed interest rate payable by the company.

Guaranteed Interest Rate — That interest rate which is stated by the company to be paid on funds in the guaranteed account.

Guaranteed Minimum Surrender Value — The minimum amount defined in the contract that the owner is guaranteed to receive upon surrender of the annuity after the application of surrender charges and market value adjustments, if any.

Guaranty Association — Each state, by statute, has a Guaranty Association that backs fixed annuity products up to certain dollar limits, to protect policyholders from financial loss due to the insolvency of an insurance company.

Hybrid Annuity — A specialized contract that allows buyers to allocate funds to both fixed and variable annuity components.

Immediate Annuity — A type of annuity that is designed to provide a guaranteed income stream, most typically for an individual or joint lifetime, with payments beginning in less than one year. They can also be structured to provide guaranteed income for a specified period of time.

Income Account Value — The value used to determine the amount of guaranteed lifetime income generated once that feature is activated.

Income Rider — An optional benefit that can be added to some annuity contracts, usually for a fee, that is designed to help generate a higher level of guaranteed lifetime income at a future date.

Installment Refund — A type of immediate annuity payout method where the insurance company guarantees that the total payout will not be less than the amount paid to purchase the annuity. If the annuitant dies before receiving payments that equal the purchase price, the difference is paid to the named beneficiaries in installments.

Intermediary — An entity contracted directly with an insurer or with another entity contracted with an insurer to facilitate the sale of the insurer’s annuities by producers.

Joint Annuitant — A person whose life, jointly with the primary annuitant, the annuity policy is based upon and also receives the benefits of the contract.

Joint Life Annuity — An annuity payment option that provides guaranteed income payments for as long as either the annuitant or joint annuitant is living.

Joint Owner — A person or legal entity that, jointly with another person or legal entity, applies for and buys an annuity contract. These are the parties that co-own the annuity and whose funds were used to purchase the policy.

Life Annuity — An annuity payment option that provides guaranteed income payments for as long as the annuitant is living.

Longevity Annuity — An annuity product designed to provide a guaranteed lifetime income stream beginning at a predetermined future date. (Can also be referred to as a deferred income annuity)

Margin or Spread — A specified percentage used in certain calculation methods with fixed indexed annuities to determine the amount of index-linked interest that is credited to the annuity. The margin or spread percentage is deducted from the total calculated change in the index value; however, the annual interest credit will never be less than zero.

Market Value Adjustment (MVA) — An adjustment formula applied to withdrawals made in excess of penalty free amounts, or full contract surrenders, during the time in which the annuity is still subject to the surrender period. The adjustment may decrease or increase the amount of withdrawal, depending on the change in interest rates during the period since the annuity was first purchased.

Material Conflict of Interest — A financial interest of the producer in the sale of an annuity that a reasonable person would expect to influence the impartiality of a recommendation. Material conflict of interest does not include cash compensation or non-cash compensation.

Maturity Date — The date on which annuity payments begin. It is the date specified within the annuity contract at which time the owner must elect a settlement option and begin receiving payments by way of annuitizing the contract.

Minimum Premium — The minimum initial payment required to purchase an annuity. Future amounts paid into the annuity can vary by product design and tax status of funds.

Monthly Averaging — An index annuity interest crediting method that is calculated by comparing the underlying index value on the first day of the contract year to the monthly average of that same index at the end of the year. The monthly average index value equals the sum of the monthly index values recorded each month over

the course of the preceding contract year, divided by twelve. At the end of each annual index term, the percentage change between the index starting value and the index monthly average value is used in determining the amount of interest that is credited to the annuity, if any.

Monthly Point-to-Point — An index annuity crediting method that measures the percentage change in the underlying index value each month. Usually, each monthly change is limited by a cap for positive changes, but not for negative changes. At the end of each index term, typically every contract year, all o the monthly percentage changes are added together to determine the amount of interest that is credited to the annuity, if any.

Multi-Year Guarantee Annuities — A type of fixed annuity in which the interest rate is guaranteed in advance for a set number of years.

Nonguaranteed Elements — The premiums, credited interest rates (including any bonus), benefits, values, dividends, non-interest based credits, charges or elements of formulas used to determine any of these, that are subject to company discretion and are not guaranteed at issue. An element is considered nonguaranteed if any of the underlying nonguaranteed elements are used in its calculation.

Nonqualified Contract — Nonqualified encompasses every type of funds, except those held within a tax qualified account, such as an IRA or 401(k).

Owner — The person or entity to whom the contract is issued, who is entitled to exercise all rights and privileges under the contract.

Participation Rate — This rate determines what percentage of the increase in an index will be used to calculate index-linked interest credits to a fixed indexed annuity.

Payee — The owner, annuitant, beneficiary or any other person or legal entity to which benefits are paid.

Penalty Free Withdrawals — The amounts specified in an annuity contract that can be withdrawn on a penalty free basis, even during the time in which the annuity is subject to early surrender charges.

Pension — A pension is generally a series of definitely determinable payments made to you after you retire from work. Pension payments are made regularly and are based on such factors as years of service and prior compensation.

Period Certain — An immediate annuity payment term in which income payments are made by the insurance company for a predetermined period of time only.

Point-to-Point — An index annuity crediting method that measures the percentage change in the underlying index value between two dates to determine the amount of interest credit applied to the contract.

Policy — The legally binding contract issued by the insurance company that defines the terms, conditions and benefits of the annuity.

Premium — The collective total of the initial payment, and any subsequent payments, made to purchase an annuity, excluding earned interest.

Premium Bonus — The percentage added by the insurance company to premium payments made by the annuity owner. Bonuses are frequently subject to a vesting schedule.

Premium Tax — A taxed charged by the state or any other governmental authority on either the premium payment or value of the separate account.

Principal — The collective total of the initial premium deposit, and any subsequent premium deposits, paid to purchase an annuity, excluding earned interest.

Prospectus — A legal document that must be delivered, under Securities and Exchange Commission (SEC) regulations, to the prospective buyer of a variable annuity before the actual sale, providing details about the variable annuity offering.

Qualified Contract — A contract issued under an Individual Retirement Arrangement under section 408(b), a Tax Sheltered Annuity under section 403(c), 401(k) profit sharing plans and deferred compensation plans under section 457 of the IRS code.

Recommendation — Advice provided by a producer to an individual consumer that was intended to result or does result in a purchase, an exchange or a replacement of an annuity in accordance with that advice.

Renewal Rate — The interest rate offered by an insurance company on an in-force fixed annuity after the initial guarantee period is over.

Required Minimum Distribution (RMD) — The amount that IRA owners and qualified plan participants must begin withdrawing from their retirement accounts by April 1 following the year in which they reach age 72. Required minimum distribution withdrawals must then be taken each subsequent year.

Rollover — Refers to the moving of tax qualified monies from one retirement plan or IRA to another in such a way so as not to incur or suffer any tax consequences, maintaining the tax-deferred status of the funds.

SEC — The United States Securities and Exchange Commission.

Separate Account — Those assets that are segregated by the issuing insurance company from all other assets of the company. These assets are invested and managed by professional portfolio managers similar to that of a mutual fund.

Single Premium — A kind of annuity contract that is established with a single lump sum premium payment. Additional funds cannot be added to this type of annuity after it is issued.

Single Premium Immediate Annuity (SPIA) — A type of annuity that is designed to provide a guaranteed income stream, most typically for an individual or joint lifetime, with payments beginning in less than one year. They can also be structured to provide guaranteed income for a specified time period.

Split Funded Annuity — An annuity concept in which the initial premium is divided between two separate annuity contracts, structured in such a way as to produce immediate tax-advantaged income for a guaranteed period of time and to restore the original principal at the end of that time period. A multi-year guarantee annuity is used to restore the original principal at the end of the guarantee period, while an immediate annuity provides the monthly income.

Spread or Margin — A specified percentage used in certain calculation methods with fixed indexed annuities to determine the amount of index-linked interest that is credited to the annuity. The spread or margin percentage is deducted from the total calculated change in the index value; however, the annual interest credit will never be less than zero.

Subaccount — That portion of the separate account that invests in shares of stock comprising it's own portfolio with specific investment objectives.

Surrender Charge — A penalty imposed by the insurance company for terminating, or exceeding the penalty free withdrawal provisions of, an annuity contract during the surrender period. Surrender charges are charged against the account value and are charged for a period of time specified in the contract. It is not unusual to have a surrender charge period of 14-15 years.

Surrender Period — The period of time for which an annuity contract is subject to early surrender charges or penalties.

Term Current Annual Yield — The annual yield, including bonuses if applicable, up to the first penalty free full withdrawal window, assuming the current base interest rate remains unchanged for the duration of the term.

Term Guaranteed Annual Yield — The annual yield, including bonuses if applicable, up to the first penalty free withdrawal window, assuming the interest rate is reduced to the contractually guaranteed minimum at the first available opportunity, for the duration of the term.

Upfront Bonus — The amount added by the insurance company to a bonus annuity value, usually a set percentage of the premium paid when the contract is purchased or when money is added to the contract.

Variable Annuity — An annuity under which the company will make to the annuitant or any other payee designated by the owner of the contract, payments which vary in amount in accordance with the net investment experience of the subaccounts selected by the owner.

Withdrawal Charge — A penalty imposed by the insurance company to withdrawals made in excess of specified penalty free amounts, or full contract surrenders, during the time in which the annuity is still subject to the surrender period.

Withdrawal Window — The period of time, typically 30 days, at the end of an annuity guarantee period when the contract owner has the option to withdraw or transfer funds, or surrender the contract without any surrender charges or market value adjustment fees. Usually, if no action is taken, the annuity will renew for an additional guarantee period equal to the one just completed.

Yield — The total average annual interest rate percentage earned with a fixed annuity over a specified time period, including any premium bonus or interest rate enhancements.

VARIATIONS OF ANNUITIES

There are also several variations of annuities. In this course, we will study each of these listed, as well as others, and the variable components they encompass.

- **Fixed annuities** — Guaranteed interest rates and fixed investment
- **Fixed Indexed annuities** — No-risk market exposure
- **Variable annuities** — Maximum stock market exposure

- **Indexed Variable annuities** — Account performance simulates market index performance
- **Hybrid annuities** — Takes benefits of both annuitized and deferred contracts without the negatives

ANNUITIES AS DEFINED BY THE SECURITIES AND EXCHANGE COMMISSION

An annuity is a contract between you and an insurance company that is designed to meet retirement and other long-range goals, under which you make a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date.

Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a specified minimum amount, such as your total purchase payments. While tax is deferred on earnings growth when withdrawals are taken from the annuity, gains are taxed at ordinary income rates, and not capital gains rates. If you withdraw your money early from an annuity, you may pay substantial surrender charges to the insurance company, as well as tax penalties.

There are generally three types of annuities—fixed, indexed, and variable—though there are many variations of each. In a fixed annuity, the insurance company agrees to pay no less than a specified rate of interest during the time that the account is growing. The insurance company also agrees that the periodic payments will be a specified amount per dollar in the account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as the annuitant's lifetime or the lifetime of the annuitant and their spouse.

In an indexed annuity, the insurance company credits you with a return that is based on changes in an index, such as the Standard & Poor's 500 Composite Stock Price Index. Indexed annuity contracts also provide that the contract value will be no less than a specified minimum, regardless of index performance.

In a variable annuity, the contract owner can choose to invest the premium payments from among a range of different investment options, typically mutual funds. The rate of return, and the amount of the periodic payments the annuitant eventually receives, will vary depending on the performance of the investment options selected.

Variable annuities are securities regulated by the Securities and Exchange Commission. An indexed annuity may or may not be a security; however, most indexed annuities are not registered with the Securities and Exchange Commission.

Fixed annuities are not securities and are not regulated by the Securities and Exchange Commission.

VARIABLE ANNUITIES

A variable annuity is a contract between a consumer and an insurance company, under which the consumer (contract owner) makes a lump sum payment or series of payments. In return, the insurer agrees to make periodic payments to the annuitant beginning immediately or at some future date. The contract owner can choose to invest purchase payments in a range of investment options, which are typically mutual funds. The value of the account in a variable annuity will vary depending on the performance of the investment options chosen.

Variable annuities often also offer many features including:

- Tax deferral on earnings;
- A death benefit that will pay to the contract's beneficiary a specified amount—typically at least the amount of the purchase payments—if the annuitant dies before the insurer has started making payments; and
- The option of receiving a stream of periodic payments for either a definite period such as 20 years, or for an indefinite period such as lifetime or the life of a spouse.

Variable annuities also often offer optional living benefit features that provide certain protections for payouts, withdrawals or account values, against the effect of investment losses and/or unexpected longevity. (These benefits will be discussed in depth as we progress through the course material.)

IT ALL BEGINS WITH AN APPLICATION

The purchase of an annuity is structured in the same way as the purchase of a certificate of deposit or mutual fund—through an application and/or agreement between the investor (contract owner) and the financial institution (insurer).

The contract owner must supply an application, which furnishes the following information:

- Contract owner name,
- Current address of the contract owner,
- Social Security number of the contract owner,

- Name, Social Security number, address, sex and date of birth of the annuitant,
- Investment options,
- Type of funds utilized,
- Signature of the contract owner, and the
- Signature of the annuitant.

The annuity contract defines specific guidelines, such as:

- Additional investing,
- Withdrawals,
- Cancellations,
- Penalties, and
- Guarantees.

A client investing in an annuity must complete an application. Once the application has been submitted to the insurer, the contract owner receives the contract, which contains a summary of the application, the rate of expected return on the investment(s) and type(s) of investments selected.

ISSUE AGE GUIDELINES

Most insurance companies allow annuities to be purchased by individuals (both contract owner and annuitant) until they are age 90. Minimum issue age is often set at age zero (0). However, other insurance companies will set the maximum age for contract owners and annuitants to be 80 or 85. Some annuities will have shorter surrender charge periods for issues ages over a certain age (usually age 70). Many annuity companies will offer multiple annuity products with some products not available for clients over a certain age.

The minimum and maximum issue ages are usually expressed as the age of the annuitant, but many insurers will specify the minimum or maximum issue age applies to the owner or annuitant.

ANNUITY DATE

The annuity date is the date at which the annuitant begins to receive annuity payments. This date is the earlier of the optional date elected by the annuitant or the maturity date. The maturity date is the latest date the annuitant may defer annuity

payout options and is stated in the contract. Many contracts stipulate that the annuitant may change the maturity date; however, the new maturity date may be the last day of the term but may be no later than the maximum age stated in the contract. The maturity date is often misunderstood. It is typically the last date by which the annuitant must take receipt of the proceeds—and not the first date on which proceeds may be withdrawn without surrender penalties.

The IRS does not require age limits when benefits are paid but most insurance companies establish annuitization limits at age 80 to 85; others establish the maximum age at 100. It is important for an agent to know what age maximums apply to both contract owners and annuitants, since differing age limits will affect a variety of features of an annuity.

THE RIGHT ANNUITY FOR THE RIGHT CONSUMER

An annuity is not for everyone. For instance, those who need current income should not even consider the deferred annuity. Though it is one of the safest ways to accumulate dollars on a tax advantaged basis, monies designated for short-term needs should not be invested in an annuity. It is recommended that purchasers should also have at least six months' worth of income on deposit outside of the annuity.

Find the Right Annuity for the Right Consumer!

First of all, there are so many varieties with so many different features: Fixed, Variable, CD-type, Bond Index, Single Premium, Indexed, Tax Sheltered, Market Adjusted, Impaired Risk…

No matter what the variety, the right annuity can present several advantages for the right consumer. Annuities generally enjoy the reputation as being safe vehicles for investment—they can be easily monitored, they offer tax-deferred growth on earnings, they provide resources that can last as long as needed, and they can offer a money back guarantee.

The insurer who issues the annuity backs the annuity value thereby making an annuity desirable for anyone who wants a safe way to reduce taxes and who wants to decide when to pay taxes.

As time goes by, individual situations change with respect to available discretionary income, tax brackets, and family situations. In addition, tax law changes, program

availability, and feature modifications are constantly being reviewed and updated. Some people save specifically for retirement and education, whereas others save for the future (retirement) exclusively, and take care of education as best they can when it occurs. Yet the fundamentals seldom change.

The more one puts away today,
the more it grows for tomorrow!

Accumulating funds for the future depends on money, time, a vehicle, and consistency. With so many ways to save, the real key is to start putting aside funds as soon as possible. The more one puts away today, the more it grows for tomorrow. The higher yield or growth each dollar earns makes it compound faster and greater. The smaller the amount of taxes paid upon contribution and during growth, the faster funds accumulate for their intended purpose. And, when people plan for certain amounts to be available at specific times in the future, they are more motivated to put money aside on a regular basis to meet that goal.

As with any other insurance product, one must carefully consider their personal situation and how they feel about the choices available. No single annuity design may have all the features they want. It is important to understand the features and trade-offs in order to choose the right annuity.

Keep in mind that it may be misleading to compare one annuity to another unless one compares all the other features of each annuity. Clients must decide for themselves what combination of features makes the most sense for them.

Also, remember that it is not possible to predict the future market behavior of an index.

CONSUMER TIMEFRAME AND OBJECTIVES

Since most annuities have either a surrender charge or a contingent deferred sales charge and/or are equity based, a client needs to manage liquidity when investing in an annuity. Annuities are considered long-term products and are not generally used

for short-term goals. Also since annuities do not enjoy the stepped-up basis treatment at death for income tax purposes, they are not the most effective vehicle for wealth transfer.

IS AN ANNUITY RIGHT FOR THIS CONSUMER?

To find out if an annuity is right for the consumer, think about what their financial goals are for the future. Analyze the amount of money they are willing to invest in an annuity, as well as how much of a monetary risk they are willing to take. Consumers shouldn't buy an annuity to reach short-term financial goals. When determining whether an annuity would benefit the consumer, the following questions need to be answered.

- How much retirement income will they need in addition to what they will get from Social Security and any pension plan?
- Will they need supplementary income for others in addition to themselves?
- How long do they plan on leaving money in the annuity?
- When do they plan on needing income payments?
- Will the annuity allow the consumer to gain access to the money when they need it?
- Do they want a fixed annuity with a guaranteed interest rate and little or no risk of losing the principal? **OR**
- Do they want a variable annuity with the potential for higher earnings that are not guaranteed with the possibility that they may risk losing principal? **OR**
- Are they somewhere in between and willing to take some risks with an indexed annuity?

REASONS TO PURCHASE AN ANNUITY

Though annuities are not for everyone, statistics show that Americans have invested over three trillion dollars in annuities. Here are some of the reasons why.

- **Safety** – Insurance companies are forced to set aside $1 for every $1 invested into annuities. Banks fail many times because they take $1 and make $10 in loans that go bad. Annuities don't do this.
- **Guaranteed income for life** – Annuities can fill in the gaps when Social Security, pensions and other retirement accounts don't provide enough

retirement income. Annuities allow you to take a lump sum today and create a steady stream of income paid monthly, quarterly or yearly.

- **Reasonable returns** – Traditional fixed annuities provide a safe alternative to bank CD's and savings accounts. Some uncapped index annuities have earned high percentages in specific years. You earn a portion of market upside without risking your principal. Some of the gains, none of the losses.
- **Tax-deferred growth** – Annuities offer triple compounding on the interest. Earn interest on the principal, interest on the interest, and interest on the money normally lost to taxes.
- **Long Term Care Benefits** – Some annuities offer 200-300% of your initial deposit in long-term care benefits with an optional rider. Everyone qualifies regardless of health.
- **Leave a Legacy** – You can leave a loved one a monthly, quarterly or annual check. This can be especially beneficial if you think they might not spend a lump sum payment wisely.
- **Bonuses** – Some annuities offer upfront bonuses on deposits. Example, invest $100,000 and receive a $10,000 bonus.[1]

INSURER FISCAL RESPONSIBILITY

Due to the sheer volume of insurance companies, they collectively own, manage, or control more assets than all of the oil companies in the world combined or all the banks in the world combined. It was the insurance companies that came to the rescue of the banking industry during The Great Depression, not the federal government.

INSURANCE COMPANY RESERVES

Insurance Reserves – "A stated amount or percent of liquid assets that an insurer must have on hand that will satisfy all claims from in-force insurance contracts and other outstanding liabilities Reserve limits are established by state regulatory agencies which calculate reserves as a percent of the total present value of in-force insurance less the present value of future premiums to be received plus interest."[2]

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[1] Annuity Resources, Nov. 2019, https://www.annuityresources.org/bestannuities

[2] InvestorWords.com

Reserves reflect an insurance company's ability to pay claims. State insurance departments set minimum reserve requirements for their insurance carriers.

The claims reserves represent the money set aside to pay policyholders who have filed or are expected to file claims. The claims reserve, aka balance sheet reserve, is used to pay out incurred claims that have yet to be settled. These reserves can be used for settling withdrawals and redeeming annuities; but cannot be used to pay any non-related annuity items (i.e., bad debts, overhead, claims).

Since the insurance company's annuity business represents their smallest source of revenue, companies use money from other profit centers for this reserve fund.

The investor is protected by a legal reserve pool, which has mandatory membership for insurance companies in most states. The reserve pool's purpose is to carryout the liabilities and obligations of the investor should the original insurer go out of business.

INSURANCE COMPANY RATINGS

As with any business, insurance companies have independent ratings. Even though annuities may have a perfect track record, the Insurer's rating should also be taken into consideration. For a fixed rate annuity, investors prefer an "A" or "A+" rating. For variable annuities, since earnings are not dependent upon the Insurer's solvency, the ratings are not so crucial.

A.M. Best, the oldest rating company in the United States, rates companies in much the same manner as our public school system, from A+ to F, plus additional categories.

Following is A.M. Best's Financial Strength Rating (FSR) guide as an example.

Best's Financial Strength Rating (FSR) Scale			
Rating Categories	**Rating Symbols**	**Rating Notches***	**Category Definitions**
Superior	A+	A++	Assigned to insurance companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.
Excellent	A	A-	Assigned to insurance companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.
Good	B+	B++	Assigned to insurance companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.
Fair	B	B-	Assigned to insurance companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Marginal	C+	C++	Assigned to insurance companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Weak	C	C-	Assigned to insurance companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is very vulnerable to adverse changes in underwriting and economic conditions.
Poor	D	-	Assigned to insurance companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations. Financial strength is extremely vulnerable to adverse changes in underwriting and economic conditions.
*Each Best's Financial Strength Rating Category from "A+" to "C" includes a Rating Notch to reflect a gradation of financial strength within the category. A Rating Notch is expressed with either a second plus "+" or a minus "-".			

Financial Strength Non-Rating Designations	
Designation Symbols	**Designation Definitions**
E	Status assigned to insurance companies that are publicly placed under a significant form of regulatory supervision, control or restraint - including cease and desist orders, conservatorship or rehabilitation, but not liquidation - that prevents conduct of normal ongoing insurance operations; an impaired insurer.
F	Status assigned to insurance companies that are publicly placed in liquidation by a court of law or by a forced liquidation; an impaired insurer.
S	Status assigned to insurance companies to suspend the outstanding FSR when sudden and significant events impact operations and rating implications cannot be evaluated due to a lack of timely or adequate information; or in cases where continued maintenance of the previously published rating opinion is in violation of evolving regulatory requirements.
NR	Status assigned to insurance companies that are not rated; may include previously rated insurance companies or insurance companies that have never been rated by A.M. Best.

Table 1.1

Other rating sources to look at are Standard & Poor's and Moody's. In their review of the annuities market, Standard & Poor's maintain the belief that the life insurance industry, which offers annuity products, remains the strongest in the financial services sector. This view is based upon the fact that the industry as a whole has a very strong balance sheet.

PROFESSIONAL COMPETENCE

The professional management team plays a very important role in the annuity field, and each member is considered a specialist in his/her field. These specialists are licensed and regulated by the federal government and state insurance department and are highly skilled and trained to focus on a certain segment of the marketplace. As with overall ratings, independent sources track performance of annuities.

Specialized publications such as *The Wall Street Journal* can provide excellent articles on annuities and annuity performances.

STATE GUARANTY ASSOCIATIONS

An insurance guaranty association is a state-sanctioned organization that protects policyholders and claimants in the event the insurance company that provided the annuity fails financially (i.e., impairment or insolvency)—their investment is protected by state law. Coverage is typically allocated for individual policyholders, not group contracts.

Guaranty associations assure that the claims of an insolvent insurance company's resident policyholders will be paid, subject to the limits of the law. All insurers authorized to write life insurance, health insurance, and annuities in the state are required to be members of the association.

Instead of federal protection, such as banks being backed by the FDIC, consumers are protected at the state level—since insurance companies are regulated by individual states, not the federal government.

THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATION

The National Organization of Life and Health Insurance Guaranty Association (NOLHGA) is a voluntary association made up of the life and health insurance guaranty associations of all 50 states and the District of Columbia.

NOLHGA was founded in 1983 when the state guaranty associations determined that there was a need for a mechanism to help them coordinate their efforts to provide protection to policyholders when a life or health insurance company insolvency affects people in many states.

State life and health insurance guaranty associations provide a safety net for their state's policyholders, ensuring that they continue to receive coverage (up to state-specific limits), even if their insurer is declared insolvent.

When a company enters a period of financial difficulty and is unable to meet its obligations, the insurance commissioner in the company's home state initiates a process—dictated by the laws of the state—whereby efforts are made to help the company regain its financial footing. This period is known as **rehabilitation**.

If it is determined that the company cannot be rehabilitated, the company is declared insolvent, and the commissioner will ask the state court to order the liquidation of the company.

ROLE OF THE INSURANCE COMMISSIONER

The insurance commissioner, either appointed by the governor or elected, heads the state insurance department and monitors and regulates insurance activity within the state. The commissioner also has the responsibility to determine when an insurance company domiciled in the state should be declared insolvent and to seek authority from the state court to seize its assets and operate the company pending rehabilitation or liquidation.

ROLE OF THE RECEIVER

By obtaining control of a company, the commissioner (or the insurance department) is, by law, the rehabilitator or liquidator of the company. In this capacity, the commissioner or department takes control of the company's operations. Rather than do so directly, the commissioner may retain a special deputy receiver to supervise the company's activities. The receiver may be an employee of the state insurance department or an independent professional experienced in legal, accounting, and actuarial issues.

The receiver oversees an accounting of the company's assets and liabilities and administers the estate of the company. In doing so, the receiver seeks to maximize the company's assets, transfer them to cash, and then distribute that cash to creditors having valid claims against the insurer in accordance with payment priorities

specified by state law (in all states, policyholders are priority claimants whose claims are paid before those of general creditors).

GUARANTEED COVERAGE

Each state guaranty association specifies the lines of insurance covered and the limits payable. Most states cover an average of $250,000 to $300,000; however, some states cover much more.

While laws governing maximum limits and types of policies covered vary from state to state, most states are consistent with the NAIC Model Act and provide coverage at least in the amounts specified below.

- $300,000 in life insurance death benefits
- $100,000 in cash surrender or withdrawal values for life insurance
- **$250,000 in present value of annuity benefits, including net cash surrender/withdrawal values**
- $500,000 in major medical or basic hospital, medical and surgical insurance policy benefits
- $300,000 in long-term care insurance policy benefits
- $300,000 in disability insurance policy benefits
- $100,000 in other health insurance benefits

In most states, the aggregate benefit level for an individual life in any one insolvency is $300,000; except if there is covered major medical insurance or covered basic hospital, medical and surgical insurance, in which case the aggregate benefit is $500,000. Coverage levels apply separately for each insolvent insurer.

HOW COVERAGE IS FUNDED

When an insurer fails and there is a shortfall of funds needed to meet the obligations to policyholders, state guaranty associations are activated. Guaranty associations have two main sources of funding when providing coverage to policyholders. First, guaranty associations have subrogation rights to a proportionate share of the assets remaining in the failed insurer. Those assets, which can be substantial, may be used by the guaranty associations to pay covered claims. Second, insurers doing business in that state are assessed a share of the amount required to meet the portion of the guaranty associations' covered claims not otherwise funded with estate assets. The

amount insurers are assessed is based on the amount of premiums that they collect in that state.

ADVERTISING PROHIBITION

In most states, insurance agents are prohibited from advertising the funds' availability as a sales tool.

Following is a typical statute regarding the advertising restriction.

> "**Prohibited advertisement of insurance sales; required notice**"
>
> (a) A person, including a member insurer, agent, or affiliate of a member insurer, may not make, publish, disseminate, circulate, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in any newspaper, magazine, or other publication, or in the form of a notice, circular, pamphlet, letter, or poster, or over any radio station or television station, or in any other way, an advertisement, announcement, or statement, written or oral, that uses the existence of the association for the purpose of sales, solicitation, or inducement to purchase any form of insurance or other coverage covered by the association. However, this section does not apply to the association or any other entity that does not sell or solicit insurance, coverage by a hospital or medical service corporation, or coverage by a health maintenance organization.[3]

NOTICE TO POLICYOWNERS

Section 19 of the NAIC Life and Health Guaranty Association Model Act prohibits advertisement of the Insurance Guaranty Association in insurance sales.

A. No person, including a member insurer, agent or affiliate of a member insurer shall make, publish, disseminate, circulate or place before the public, or cause directly or indirectly, to be made, published, disseminated, circulated or placed before the public, in any newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio station or television station, or in any other way, any advertisement, announcement or statement, written or oral, which uses the existence of the Insurance Guaranty Association of this State

[3] Alaska § 21.79.160

for the purpose of sales, solicitation or inducement to purchase any form of insurance or other coverage covered by the [State] Life and Health Insurance Guaranty Association Act. However, this section shall not apply to the [State] Life and Health Insurance Guaranty Association or any other entity that does not sell or solicit insurance or coverage by a health maintenance organization.

Section 19 also requires that a state's summary notice be approved by the commissioner and must be delivered to all policyowners within 60 days of the commissioner's approval.

B. Within one hundred eighty (180) days of the effective date of this Act, the Association shall prepare a summary document describing the general purposes and current limitations of the Act and complying with Subsection C of this section. This document shall be submitted to the commissioner for approval. At the expiration of the sixtieth day after the date on which the commissioner approves the document, a member insurer may not deliver a policy or contract to a policyowner, contract owner, certificate holder, or enrollee unless the summary document is delivered to the policyowner, contract owner, certificate holder, or enrollee at the time of delivery of the policy or contract. The document shall also be available upon request by a policyowner, contract owner, certificate holder, or enrollee. The distribution, delivery or contents or interpretation of this document does not guarantee that either the policy or the contract or the policyowner, contract owner, certificate holder, or enrollee is covered in the event of the impairment or insolvency of a member insurer. The description document shall be revised by the Association as amendments to the Act may require. Failure to receive this document does not give the policyowner, contract owner, certificate holder, enrollee, or insured any greater rights than those stated in this Act.

The summary notice must also contain a disclaimer on the first page, Life and Health Insurance Guaranty Association Disclaimer, warning policyowners that the Association may not cover the contract value; but, if coverage is available, it will be subject to limitations.

C. The document prepared under Subsection B shall contain a clear and conspicuous disclaimer on its face. The commissioner shall establish the form and content of the disclaimer. The disclaimer shall:

(1) State the name and address of the Life and Health Insurance Guaranty Association and insurance department;

(2) Prominently warn the policyowner, contract owner, certificate holder, or enrollee that the Life and Health Insurance Guaranty Association may not

cover the policy or contract or, if coverage is available, it will be subject to substantial limitations and exclusions and conditioned on continued residence in this State;

(3) State the types of policies or contracts for which guaranty funds will provide coverage;

(4) State that the member insurer and its agents are prohibited by law from using the existence of the Life and Health Insurance Guaranty Association for the purpose of sales, solicitation or inducement to purchase any form of insurance or health maintenance organization coverage;

(5) State that the policyowner, contract owner, certificate holder, or enrollee should not rely on coverage under the Life and Health Insurance Guaranty Association when selecting an insurer or health maintenance organization;

(6) Explain rights available and procedures for filing a complaint to allege a violation of any provisions of this Act; and

(7) Provide other information as directed by the commissioner including but not limited to, sources for information about the financial condition of insurers provided that the information is not proprietary and is subject to disclosure under that State's public records law.

D. A member insurer shall retain evidence of compliance with Subsection B for so long as the policy or contract for which the notice is given remains in effect.

The [insert name of the Life and Health Insurance Guaranty Association] provides coverage of claims under some types of policies or contracts if the insurer or health maintenance organization becomes impaired or insolvent. COVERAGE MAY NOT BE AVAILABLE FOR YOUR POLICY. Even if coverage is provided, there are significant limits and exclusions. Coverage is always conditioned on residence in this State. Other conditions may also preclude coverage.

The Life and Health Insurance Guaranty Association will respond to any questions you may have which are not answered by this document. Your insurer or health maintenance organization and agent are prohibited by law from using the existence of the association or its coverage to sell you an insurance policy or health maintenance organization coverage.

You should not rely on availability of coverage under the Life and Health Insurance Guaranty Association when selecting an insurer or a health maintenance organization.

[Insert addresses of the Association and department.]

Insurers, health maintenance organizations and agents should be required to deliver the document and disclaimer described under Subsections B and C when a customer is solicited if a “free look” period is not required by State law.

Computer programs or other evidence of established procedures for including the notice required under Subsection 19B in the policy or contract in the printing, assembly or issue process would be considered evidence of the compliance required under Subsection 19D.

THE NAIC LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATION MODEL ACT

The purpose of this Act is to protect, subject to certain limitations, the persons specified in Section 3A against failure in the performance of contractual obligations, under life, health, and annuity policies, plans, or contracts specified in Section 3B, because of the impairment or insolvency of the member insurer that issued the policies, plans, or contracts.

To provide this protection, an association of member insurers is created to pay benefits and to continue coverages as limited by this Act, and members of the Association are subject to assessment to provide funds to carry out the purpose of this Act.

CREATION OF THE ASSOCIATION

Section 6. Creation of the Association. A. There is created a nonprofit legal entity to be known as the [State] Life and Health Insurance Guaranty Association. All member insurers shall be and remain members of the Association as a condition of their authority to transact insurance or a health maintenance organization business in

this State. The Association shall perform its functions under the plan of operation established and approved under Section 10 and shall exercise its powers through a board of directors established under Section 7. For purposes of administration and assessment, the Association shall maintain two (2) accounts:

(1) The life insurance and annuity account which includes the following subaccounts:

(a) Life insurance account;

(b) Annuity account which shall include annuity contracts owned by a governmental retirement plan (or its trustee) established under Section 401, 403(b) or 457 of the United States Internal Revenue Code, but shall otherwise exclude unallocated annuities; and

(c) Unallocated annuity account, which shall exclude contracts owned by a governmental retirement benefit plan (or its trustee) established under Section 401, 403(b) or 457 of the United States Internal Revenue Code.

(2) The health account.

B. The Association shall come under the immediate supervision of the commissioner and shall be subject to the applicable provisions of the insurance laws of this State. Meetings or records of the Association may be opened to the public upon majority vote of the board of directors of the Association.

COVERAGE AND LIMITATIONS

Section 3. Coverage and Limitations. A. This Act shall provide coverage for the policies and contracts specified in Subsection B:

(1) To persons who, regardless of where they reside (except for nonresident certificate holders under group policies or contracts), are the beneficiaries, assignees or payees, including health care providers rendering services covered under health insurance policies or certificates, of the persons covered under Paragraph (2);

(2) To persons who are owners of or certificate holders or enrollees under the policies or contracts (other than unallocated annuity contracts, and structured settlement annuities) and in each case who:

(a) Are residents; or (b) are not residents, but only under all of the following conditions:

(i) The member insurer that issued the policies or contracts is domiciled in this State;

(ii) The States in which the persons reside have associations similar to the association created by this Act;

(iii) The persons are not eligible for coverage by an association in any other State due to the fact that the insurer or the health maintenance organization was not licensed in the State at the time specified in the State's guaranty association law.

(3) For unallocated annuity contracts specified in Subsection B; Paragraphs (1) and (2) of this subsection shall not apply, and this Act shall (except as provided in Paragraphs (5) and (6) of this subsection) provide coverage to:

(a) Persons who are the owners of the unallocated annuity contracts if the contracts are issued to or in connection with a specific benefit plan whose plan sponsor has its principal place of business in this State; and

(b) Persons who are owners of unallocated annuity contracts issued to or in connection with government lotteries if the owners are residents.

(4) For structured settlement annuities specified in Subsection B; Paragraphs (1) and (2) of this subsection shall not apply, and this Act shall (except as provided in Paragraphs (5) and (6) of this subsection) provide coverage to a person who is a payee under a structured settlement annuity (or beneficiary of a payee if the payee is deceased), if the payee:

(a) Is a resident, regardless of where the contract owner resides; or

(b) Is not a resident, but only under both of the following conditions:

(i) (I) The contract owner of the structured settlement annuity is a resident; or

(II) The contract owner of the structured settlement annuity is not a resident; but

a. The insurer that issued the structured settlement annuity is domiciled in this State; and

b. The State in which the contract owner resides has an association similar to the association created by this Act; and

(ii) Neither the payee (or beneficiary) nor the contract owner is eligible for coverage by the association of the State in which the payee or contract owner resides.

(5) This Act shall not provide coverage to:

(a) A person who is a payee (or beneficiary) of a contract owner resident of this State, if the payee (or beneficiary) is afforded any coverage by the association of another State; or

(b) A person covered under Paragraph (3) of this subsection, if any coverage is provided by the association of another State to the person; or

(c) A person who acquires rights to receive payments through a structured settlement factoring transaction as defined in 26 U.S.C. 5891(c)(3)(A), regardless of whether the transaction occurred before or after such section became effective.

(6) This Act is intended to provide coverage to a person who is a resident of this State and, in special circumstances, to a nonresident. In order to avoid duplicate coverage, if a person who would otherwise receive coverage under this Act is provided coverage under the laws of any other State, the person shall not be provided coverage under this Act. In determining the application of the provisions of this paragraph in situations where a person could be covered by the association of more than one State, whether as an owner, payee, enrollee, beneficiary or assignee, this Act shall be construed in conjunction with other State laws to result in coverage by only one association.

B. (1) This Act shall provide coverage to the persons specified in Subsection A for policies or contracts of direct, non-group life insurance, health insurance (which for the purposes of this Act includes health maintenance organization subscriber contracts and certificates), or annuities, and supplemental contracts to any of these, for certificates under direct group policies and contracts, and for unallocated annuity contracts issued by member insurers, except as limited by this Act. Annuity contracts and certificates under group annuity contracts include but are not limited to guaranteed investment contracts, deposit administration contracts, unallocated funding agreements, allocated funding agreements, structured settlement annuities, annuities issued to or in connection with government lotteries and any immediate or deferred annuity contracts.

(2) Except as otherwise provided in Paragraph (3) of this subsection, this Act shall not provide coverage for:

(a) A portion of a policy or contract not guaranteed by the member insurer, or under which the risk is borne by the policy or contract owner;

(b) A policy or contract of reinsurance, unless assumption certificates have been issued pursuant to the reinsurance policy or contract;

(c) A portion of a policy or contract to the extent that the rate of interest on which it is based, or the interest rate, crediting rate or similar factor determined

by use of an index or other external reference stated in the policy or contract employed in calculating returns or changes in value;

(i) Averaged over the period of four (4) years prior to the date on which the member insurer becomes an impaired or insolvent insurer under this Act, whichever is earlier, exceeds the rate of interest determined by subtracting two (2) percentage points from Moody's Corporate Bond Yield Average averaged for that same four-year period or for such lesser period if the policy or contract was issued less than four (4) years before the member insurer becomes an impaired or insolvent insurer under this Act, whichever is earlier; and

(ii) On and after the date on which the member insurer becomes an impaired or insolvent insurer under this Act, whichever is earlier, exceeds the rate of interest determined by subtracting three (3) percentage points from Moody's Corporate Bond Yield Average as most recently available;

(d) A portion of a policy or contract issued to a plan or program of an employer, association or other person to provide life, health or annuity benefits to its employees, members or others, to the extent that the plan or program is self-funded or uninsured, including but not limited to benefits payable by an employer, association or other person under;

(i) A multiple employer welfare arrangement as defined in 29 U.S.C. § 1144;

(ii) A minimum premium group insurance plan;

(iii) A stop-loss group insurance plan; or

(iv) An administrative services only contract;

(e) A portion of a policy or contract to the extent that it provides for

(i) Dividends or experience rating credits;

(ii) Voting rights; or

(iii) Payment of any fees or allowances to any person, including the policy or contract owner, in connection with the service to or administration of the policy or contract;

(f) A policy or contract issued in this State by a member insurer at a time when it was not licensed or did not have a certificate of authority to issue the policy or contract in this State;

(g) An unallocated annuity contract issued to or in connection with a benefit plan protected under the federal Pension Benefit Guaranty Corporation, regardless of whether the federal Pension Benefit Guaranty Corporation has yet become liable to make any payments with respect to the benefit plan;

(h) A portion of an unallocated annuity contract that is not issued to or in connection with a specific employee, union or association of natural persons benefit plan or a government lottery;

(i) A portion of a policy or contract to the extent that the assessments required by Section 9 with respect to the policy or contract are preempted by federal or State law;

(j) An obligation that does not arise under the express written terms of the policy or contract issued by the member insurer to the enrollee, certificate holder, contract owner or policyowner, including without limitation:

(i) Claims based on marketing materials;

(ii) Claims based on side letters, riders or other documents that were issued by the member insurer without meeting applicable policy or contract form filing or approval requirements;

(iii) Misrepresentations of or regarding policy or contract benefits; (iv) Extra-contractual claims; or

(v) A claim for penalties or consequential or incidental damages;

(k) A contractual agreement that establishes the member insurer's obligations to provide a book value accounting guaranty for defined contribution benefit plan participants by reference to a portfolio of assets that is owned by the benefit plan or its trustee, which in each case is not an affiliate of the member insurer;

(l) A portion of a policy or contract to the extent it provides for interest or other changes in value to be determined by the use of an index or other external reference stated in the policy or contract, but which have not been credited to the policy or contract, or as to which the policy or contract owner's rights are subject to forfeiture, as of the date the member insurer becomes an impaired or insolvent insurer under this Act, whichever is earlier. If a policy's or contract's interest or changes in value are credited less frequently than annually, then for purposes of determining the values that have been credited and are not subject to forfeiture under Section 3B(2)(l), the interest or change in value determined by using the procedures defined in the policy or contract will be credited as if the contractual date of crediting interest or changing values was the date of impairment or insolvency, whichever is earlier, and will not be subject to forfeiture;

(m) A policy or contract providing any hospital, medical, prescription drug or other health care benefits pursuant to Part C or Part D of Subchapter XVIII, Chapter 7 of Title 42 of the United States Code (commonly known as Medicare

Part C& D), or Subchapter XIX, Chapter 7 of Title 42 of the United States Code (commonly known as Medicaid), or any regulations issued pursuant thereto; or

(n) Structured settlement annuity benefits to which a payee (or beneficiary) has transferred his or her rights in a structured settlement factoring transaction as defined in 26 U.S.C. 5891(c)(3)(A), regardless of whether the transaction occurred before or after such section became effective.

(3) The exclusion from coverage referenced in Paragraph (2)(c) of this subsection shall not apply to any portion of a policy or contract, including a rider, that provides long-term care or any other health insurance benefits.

C. The benefits that the Association may become obligated to cover shall in no event exceed the lesser of:

(1) The contractual obligations for which the member insurer is liable or would have been liable if it were not an impaired or insolvent insurer; or

(2) (a) With respect to one life, regardless of the number of policies or contracts:

(i) $300,000 in life insurance death benefits, but not more than $100,000 in net cash surrender and net cash withdrawal values for life insurance;

(ii) For health insurance benefits:

(I) $100,000 for coverages not defined as disability income insurance or health benefit plans or long-term care insurance as defined in [section of State law dealing with health insurance/disability income insurance/long-term care insurance] including any net cash surrender and net cash withdrawal values;

(II) $300,000 for disability income insurance as defined in [section of State law dealing with health insurance/ disability income insurance], and $300,000 for long-term care insurance as defined in [section of State law dealing with health insurance/ long-term care insurance];

(III) $500,000 for health benefit plans;

(iii) $250,000 in the present value of annuity benefits, including net cash surrender and net cash withdrawal values; or

(b) With respect to each individual participating in a governmental retirement benefit plan established under Section 401, 403(b) or 457 of the U.S. Internal Revenue Code covered by an unallocated annuity contract or the beneficiaries of each such individual if deceased, in the aggregate, $250,000 in present value annuity benefits, including net cash surrender and net cash withdrawal values;

(c) With respect to each payee of a structured settlement annuity (or beneficiary or beneficiaries of the payee if deceased), $250,000 in present value annuity benefits, in the aggregate, including net cash surrender and net cash withdrawal values, if any;

(d) However, in no event shall the Association be obligated to cover more than (i) an aggregate of $300,000 in benefits with respect to any one life under Paragraphs 2(a), 2(b) and 2(c) of this subsection except with respect to benefits for health benefit plans under Paragraph 2(a)(ii) of this subsection, in which case the aggregate liability of the Association shall not exceed $500,000 with respect to any one individual, or (ii) with respect to one owner of multiple non-group policies of life insurance, whether the policy or contract owner is an individual, firm, corporation or other person, and whether the persons insured are officers, managers, employees or other persons, more than $5,000,000 in benefits, regardless of the number of policies and contracts held by the owner;

(e) With respect to either (i) one contract owner provided coverage under Subsection A(3)(b) of this section; or (ii) one plan sponsor whose plans own directly or in trust one or more unallocated annuity contracts not included in Paragraph (2)(b) of this subsection, $5,000,000 in benefits, irrespective of the number of contracts with respect to the contract owner or plan sponsor. However, in the case where one or more unallocated annuity contracts are covered contracts under this Act and are owned by a trust or other entity for the benefit of two (2) or more plan sponsors, coverage shall be afforded by the Association if the largest interest in the trust or entity owning the contract or contracts is held by a plan sponsor whose principal place of business is in this State and in no event shall the Association be obligated to cover more than $5,000,000 in benefits with respect to all these unallocated contracts.

(f) The limitations set forth in this subsection are limitations on the benefits for which the Association is obligated before taking into account either its subrogation and assignment rights or the extent to which those benefits could be provided out of the assets of the impaired or insolvent insurer attributable to covered policies. The costs of the Association's obligations under this Act may be met by the use of assets attributable to covered policies or reimbursed to the Association pursuant to its subrogation and assignment rights.

(g) For purposes of this Act, benefits provided by a long-term care rider to a life insurance policy or annuity contract shall be considered the same type of benefits as the base life insurance policy or annuity contract to which it relates.

D. In performing its obligations to provide coverage under Section 8 of this Act, the Association shall not be required to guarantee, assume, reinsure, reissue or

perform, or cause to be guaranteed, assumed, reinsured, or reissued or performed, the contractual obligations of the insolvent or impaired insurer under a covered policy or contract that do not materially affect the economic values or economic benefits of the covered policy or contract.

DEFINITIONS USED IN THE CONTEXT OF THE ACT

A. "**Account**" means either of the two accounts created under Section 6.

B. "**Association**" means the [State] Life and Health Insurance Guaranty Association created under Section 6.

C. "**Authorized assessment**" or the term "**authorized**" when used in the context of assessments means a resolution by the Board of Directors has been passed whereby an assessment will be called immediately or in the future from member insurers for a specified amount. An assessment is authorized when the resolution is passed.

D. "**Benefit plan**" means a specific employee, union or association of natural persons benefit plan.

E. "**Called assessment**" or the term "**called**" when used in the context of assessments means that a notice has been issued by the Association to member insurers requiring that an authorized assessment be paid within the timeframe set forth within the notice. An authorized assessment becomes a called assessment when notice is mailed by the Association to member insurers.

F. "**Commissioner**" means the Commissioner of Insurance of this State.

G. "**Contractual obligation**" means an obligation under a policy or contract or certificate under a group policy or contract, or portion thereof for which coverage is provided under Section 3.

H. "**Covered contract**" or "**covered policy**" means a policy or contract or portion of a policy or contract for which coverage is provided under Section 3.

I. "**Extra-contractual claims**" shall include, for example, claims relating to bad faith in the payment of claims, punitive or exemplary damages or attorneys' fees and costs.

J. "**Health benefit plan**" means any hospital or medical expense policy or certificate, or health maintenance organization subscriber contract or any other similar health contract. "Health benefit plan" does not include:

(1) Accident only insurance;

(2) Credit insurance;

(3) Dental only insurance;

(4) Vision only insurance;

(5) Medicare Supplement insurance;

(6) Benefits for long-term care, home health care, community-based care, or any combination thereof;

(7) Disability income insurance;

(8) Coverage for on-site medical clinics; or

(9) Specified disease, hospital confinement indemnity, or limited benefit health insurance if the types of coverage do not provide coordination of benefits and are provided under separate policies or certificates.

K. "**Impaired insurer**" means a member insurer which, after the effective date of this Act, is not an insolvent insurer, and is placed under an order of rehabilitation or conservation by a court of competent jurisdiction.

L. "**Insolvent insurer**" means a member insurer which after the effective date of this Act, is placed under an order of liquidation by a court of competent jurisdiction with a finding of insolvency.

M. "**Member insurer**" means an insurer or health maintenance organization licensed or that holds a certificate of authority to transact in this State any kind of insurance or health maintenance organization business for which coverage is provided under Section 3, and includes an insurer or health maintenance organization whose license or certificate of authority in this State may have been suspended, revoked, not renewed or voluntarily withdrawn, but does not include:

(1) A hospital or medical service organization, whether profit or non-profit;

(2) A fraternal benefit society;

(3) A mandatory State pooling plan;

(4) A mutual assessment company or other person that operates on an assessment basis;

(5) An insurance exchange;

(6) An organization that has a certificate or license limited to the issuance of charitable gift annuities under [insert the appropriate section of the State code]; or

(7) An entity similar to any of the above.

N. "**Corporate Moody's Bond Yield Average**" means the Monthly Average Corporates as published by Moody's Investors Service, Inc., or any successor thereto.

O. "**Owner**" of a policy or contract and "**policyholder**," "**policyowner**" and "**contract owner**" mean the person who is identified as the legal owner under the terms of the policy or contract or who is otherwise vested with legal title to the policy or contract through a valid assignment completed in accordance with the terms of the policy or contract and properly recorded as the owner on the books of the member insurer. The terms owner, contract owner, policyholder and policyowner do not include persons with a mere beneficial interest in a policy or contract.

P. "**Person**" means an individual, corporation, limited liability company, partnership, association, governmental body or entity or voluntary organization.

Q. "**Plan sponsor**" means:

(1) The employer in the case of a benefit plan established or maintained by a single employer;

(2) The employee organization in the case of a benefit plan established or maintained by an employee organization; or

(3) In a case of a benefit plan established or maintained by two (2) or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the benefit plan.

R. "**Premiums**" means amounts or considerations (by whatever name called) received on covered policies or contracts less returned premiums, considerations and deposits and less dividends and experience credits. "Premiums" does not include amounts or considerations received for policies or contracts or for the portions of policies or contracts for which coverage is not provided under Section 3B except that assessable premium shall not be reduced on account of Sections 3B(2)(c) relating to interest limitations and 3C(2) relating to limitations with respect to one individual, one participant and one policy or contract owner. "Premiums" shall not include:

(1) Premiums in excess of $5,000,000 on an unallocated annuity contract not issued under a governmental retirement benefit plan (or its trustee) established under Section 401, 403(b) or 457 of the United States Internal Revenue Code, or

(2) With respect to multiple non-group policies of life insurance owned by one owner, whether the policy or contract owner is an individual, firm, corporation or other person, and whether the persons insured are officers, managers, employees or other persons, premiums in excess of $5,000,000 with respect to these policies or contracts, regardless of the number of policies or contracts held by the owner.

S. (1) "**Principal place of business**" of a plan sponsor or a person other than a natural person means the single State in which the natural persons who establish policy for the direction, control and coordination of the operations of the entity as a whole primarily exercise that function, determined by the Association in its reasonable judgment by considering the following factors:

(a) The State in which the primary executive and administrative headquarters of the entity is located;

(b) The State in which the principal office of the chief executive officer of the entity is located;

(c) The State in which the board of directors (or similar governing person or persons) of the entity conducts the majority of its meetings;

(d) The State in which the executive or management committee of the board of directors (or similar governing person or persons) of the entity conducts the majority of its meetings;

(e) The State from which the management of the overall operations of the entity is directed; and

(f) In the case of a benefit plan sponsored by affiliated companies comprising a consolidated corporation, the State in which the holding company or controlling affiliate has its principal place of business as determined using the above factors.

However, in the case of a plan sponsor, if more than 50% of the participants in the benefit plan are employed in a single State, that State shall be deemed to be the principal place of business of the plan sponsor.

(2) The principal place of business of a plan sponsor of a benefit plan described in Subsection Q(3) of this section shall be deemed to be the principal place of business of the association, committee, joint board of trustees or other similar group of representatives of the parties who establish or maintain the benefit plan that, in lieu of a specific or clear designation of a principal place of business, shall be deemed to be the principal place of business of the employer or employee organization that has the largest investment in the benefit plan in question.

T. "**Receivership court**" means the court in the insolvent or impaired insurer's State having jurisdiction over the conservation, rehabilitation or liquidation of the member insurer.

U. "**Resident**" means a person to whom a contractual obligation is owed and who resides in this State on the date of entry of a court order that determines a member insurer to be an impaired insurer or a court order that determines a member insurer to be an insolvent insurer, whichever occurs first. A person may be a resident of only one State, which in the case of a person other than a natural person shall be its principal place of business. Citizens of the United States that are either (i) residents of foreign countries, or (ii) residents of United States possessions, territories or protectorates that do not have an association similar to the Association created by this Act, shall be deemed residents of the State of domicile of the member insurer that issued the policies or contracts.

V. "**Structured settlement annuity**" means an annuity purchased in order to fund periodic payments for a plaintiff or other claimant in payment for or with respect to personal injury suffered by the plaintiff or other claimant.

W "**State**" means a State, the District of Columbia, Puerto Rico, and a United States possession, territory or protectorate.

X. "**Supplemental contract**" means a written agreement entered into for the distribution of proceeds under a life, health or annuity policy or contract.

Y. "**Unallocated annuity contract**" means an annuity contract or group annuity certificate which is not issued to and owned by an individual, except to the extent of any annuity benefits guaranteed to an individual by an insurer under the contract or certificate.

REPORTING REQUIREMENTS

Section 15. Examination of the Association; Annual Report. The Association shall be subject to examination and regulation by the commissioner. The board of directors shall submit to the commissioner each year, not later than 120 days after the Association's fiscal year, a financial report in a form approved by the commissioner and a report of its activities during the preceding fiscal year. Upon the request of a member insurer, the Association shall provide the member insurer with a copy of the report.

TAX EXEMPTIONS

Section 16. Tax Exemptions. The Association shall be exempt from payment of all fees and all taxes levied by this State or any of its subdivisions, except taxes levied on real property.

IMMUNITY

Section 17. Immunity. There shall be no liability on the part of and no cause of action of any nature shall arise against any member insurer or its agents or employees, the Association or its agents or employees, members of the board of directors, or the commissioner or the commissioner's representatives, for any action or omission by them in the performance of their powers and duties under this Act. This immunity shall extend to the participation in any organization of one or more other State associations of similar purposes and to any such organization and its agents or employees.

STAY OF PROCEEDINGS

Section 18. Stay of Proceedings; Reopening Default Judgments. All proceedings in which the insolvent insurer is a party in any court in this State shall be stayed one hundred eighty (180) days from the date an order of liquidation, rehabilitation or conservation is final to permit proper legal action by the Association on any matters germane to its powers or duties. As to judgment under any decision, order, verdict or finding based on default the Association may apply to have such judgment set aside by the same court that made such judgment and shall be permitted to defend against such suit on the merits.

KEY POINTS TO PONDER

- An annuity is designed to provide a series of payments over a period of time; usually this period of time is over the lifetime of the annuitant named in the annuity contract.
- A.M. Best rates companies in much the same manner as our public school system, from A+ to F, plus additional categories.
- The annuity contract provides a summary of the application, the rate of expected return on the annuity's investments, and the types of investments selected.
- Fixed annuities are not considered securities and therefore are not regulated by the SEC.
- The IRS does not require age limits when benefits are paid, but most insurance companies establish annuitization limits, typically at age 80 to 85.
- Insurance producers are prohibited from using the State Guaranty Association's guarantees as a sales tool.
- Insurance companies are required to maintain their claims paying ability by setting aside reserves.
- Annuities do not contain the stepped-up basis treatment at death for income tax purposes.
- The annuity date is the date the annuitant begins to receive annuity payments.
- Most insurance companies typically allow annuities to be purchased by individuals until they reach age 90.
- The fixed annuity guarantees interest rates and immobile investments.
- The "cost basis" is the collective total of the initial premium deposit and any subsequent premium deposits paid to purchase a nonqualified annuity.
- In a bonus annuity, the insurance company adds a bonus amount to the annuity, which is usually a set percentage of the amount put into the contract.
- Annuitization is the process of converting an annuity contract's value into a guaranteed income stream represented by periodic payments made over a specified period of time, commonly for life.
- The accumulation period is the interval of time usually from the contract's date of issue to the annuity date or surrender of the contract.

- Annuities can be used for other circumstances besides retirement, such as to fund higher education expenses, fund insurance settlements, business ventures, and charitable giving.

CHAPTER 1 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. Which of the following is a TRUE statement in regard to the basic purpose of an annuity?

   a) An annuity's basic purpose is to provide a series of payments over a period of time.
   b) An annuity's basic purpose is to provide complete retirement income.
   c) An annuity's basic purpose is to supplement Social Security income.
   d) An annuity's basic purpose is to relieve the U.S. bank system of the full financial burden.

2. Once an annuity application has been submitted to the insurer, the contract owner receives the approved annuity contract. What information is contained within the contract?

   a) A summary of the application
   b) The rate of expected return on the annuity's investments
   c) The types of investments selected
   d) A summary of the application, the rate of expected return on the investments, and types of investments selected

3. The IRS does not set age limits when benefits must be paid.

   a) TRUE
   b) FALSE

CHAPTER 2

THE INNERWORKINGS OF THE ANNUITY

The primary purpose of an annuity is to provide a guaranteed income stream that one cannot outlive. An annuity works much like insurance—and like insurance, the annuity can have just as many variations.

QUALIFIED OR NONQUALIFIED – WHAT IS THE DIFFERENCE?

The Internal Revenue Code drives federal taxation and individual states follow suit. The term "**qualified**" in regard to an annuity refers to whether the annuity is a part of an employee benefit plan that has met certain requirements, or becomes "qualified" under the IRC, such as an IRA (Individual Retirement Account) or a TSA (Tax Sheltered Annuity). A qualified annuity is one that is used in connection with a qualified retirement plan. Simply put, a qualified retirement plan differs from a nonqualified arrangement in that contributions made into the qualified annuity are income tax deductible to the employer and to the account holder in the case of an IRA and TSA.

A **nonqualified annuity** may be purchased by any individual and is not associated with any employer-sponsored retirement plan or an IRA or TSA. The contributions to a nonqualified annuity are not tax deductible. While "nonqualified" may sound like a negative, it has nothing to do with the qualifications of the policy or the company issuing the annuity.

A qualified annuity is one in which payments made into the annuity are tax-deferred, similar to 401(k) plans or IRAs. A nonqualified annuity doesn't get that special treatment, and money put into it is taxed as normal.

The easiest way to define the difference between a qualified annuity and a nonqualified annuity is that qualified annuities are funded with pre-tax money, while nonqualified annuities are purchased with after-tax money.

ANNUITY GUARANTEES

A money back guarantee is a major selling feature in many annuity contracts because the contract owner is protected and the insurer assumes the risks involved. Contract owner satisfaction is guaranteed, depending upon the insurer's language relating to the principal. If the contract owner is not satisfied with their annuity, they can get all of their money back, provided that they act within the timeframe specified in the contract (free look period). The insurer may also provide a guarantee that surrender charges will not affect the principal, which allows the contract owner to get back their entire initial premium.

Guarantees are dependent upon the type of annuity purchased: Immediate vs. Deferred, Fixed vs. Variable. Following are brief descriptions regarding these products, and further discussions will provide the intricacies involved in each.

- **Immediate Annuity** — An immediate annuity begins making periodic payments quickly (within one year after purchase) to the annuitant right after the policy is issued. It is usually issued for a single lump sum premium that will give an annuitant and/or their spouse a guaranteed fixed payment. These payments may be monthly, quarterly or annually and based on one's life expectancy or that of the annuitant and their spouse.

- **Deferred Annuity** — A deferred annuity is one under which the annuity owner defers or delays receiving payments until a later date. A deferred annuity accumulates at interest for a specific period of time before the company begins making payments to the annuitant. It delays an annuitant's income stream, accumulating interest without earnings being taxed until withdrawn. People often purchase deferred annuities during their working years in anticipation of the need for retirement income later in their lives. Most deferred annuities provide a great deal of flexibility surrounding the timing and amounts of payout benefits. Deferred annuities are more common than immediate annuities.

- **Fixed Annuity** — A fixed annuity provides a guaranteed fixed interest rate while also guaranteeing the principal investment. In a fixed annuity, contract owners have the option to make either a lump sum contribution or a series of payment contributions to the contract, which in turn will pay a guaranteed rate of interest for a set period of time. Rates are typically based on the current interest rate environment. What makes an annuity "fixed" is that the insurance company promises that the money will earn a predetermined, "fixed return" per year for as long as the annuitant lives.

If a set rate of return is desired, the contract owner can choose the fixed annuity. This type of annuity guarantees that money will accumulate at a minimum specified rate of interest. However, the insurance company may pay a higher rate of interest if its investment experience is better than the minimum guarantee. Fixed annuities are most appropriate for conservative investors.

- **Variable Annuity** — A variable annuity fluctuates in value according to the performance of its investments, which are held by the company in a separate account outside their general accounts. All variable annuities are and must be registered with the Securities and Exchange Commission (SEC).

If a conservative to aggressive investment is desired, the contract owner can choose the variable annuity. With a variable annuity, the owner can choose where the money is invested. These annuities also have death benefit provisions, including an insurance company guarantee that an annuity holder is entitled to the face amount of their annuity contract, regardless of what happens to the contract's investments.

- **Hybrid Annuity** — In a hybrid annuity, annuity funds are deposited into both a fixed and a variable component. In contributing to both fixed and variable options, the annuity owner is able to obtain a guaranteed return, while at the same time participating in other types of investments that can offer additional growth of their funds.

The hybrid annuity gives investors the option to allocate funds to both a fixed and a variable annuity at the same time. Most hybrid annuities allow the investor to choose the amount of assets to allocate to the more conservative, fixed return investments, which offer a lower but guaranteed rate of return; and what amount to allocate toward more volatile variable annuity investments, which offer the potential for higher returns.

The hybrid annuity can be a valuable tool to meet long-term retirement needs as it provides the safety of principal without exposure to volatile market risk. For some, this can be very attractive. The hybrid can provide many benefits such as the potential for market-linked interest, limited upside attached to an index option, tax deferral, and the potential to add contractual benefits for income, death, and long-term care.

RISKS OF ANNUITY INVESTING

In looking ahead to their retirement years, many individuals plan on Social Security and pension plans from their employers to provide needed income for their

retirement. However, these only provide for a small portion of what is needed for income security at retirement. Because of this shortfall, people should supplement these two sources, and the purchase of annuities is one way to accomplish this.

The potential for long-term growth in an annuity is exceptional. However, as with any type of investment, caution and scrutiny are necessary. Their potential is dependent upon the market and the investments chosen. Although there are relatively few disadvantages with respect to investing in annuities—and most of them will never affect the client—there are a few to make note of, such as:

- IRS penalties for early withdrawal (i.e., excise tax)
- Insurance company penalties and fees (i.e., surrender charges, mortality and expense fees); and
- Ongoing expenses.

TAX DISADVANTAGES TO AN ANNUITY

With an annuity, if the funds are withdrawn in any method other than annuitization, **taxes are paid on gain first** (called the interest-first method of gain recognition) and the last monies withdrawn are the cost basis. This is a tax disadvantaged method of distribution and is part of the trade-off for getting total tax deferral. The only way for the owner of an annuity to get reasonable taxation during distribution is to annuitize, which most annuity owners do not do.

Another tax disadvantage to an annuity is that **all gain is taxed as ordinary income**. This is different from other investments, like mutual funds, in which a person can experience capital gains and pay considerably less taxes on the gain. For an individual who has a history of risk tolerance for equity-based investing, they are potentially trading off the capital gains treatment on distributions that they enjoy with direct stock ownership or mutual funds (provided the investment was held for at least 12 months) in exchange for total tax deferral during the accumulation phase with a variable annuity. They can get the guarantees in a variable annuity that are unavailable in equity investments without using a variable annuity.

ANNUITY FUNDING

Single premium annuities accept one premium upfront at the beginning of the contract. Flexible premium annuities allow one premium upfront and then subsequent premiums. The period of payment as well as the minimum and maximum premium payment amounts (required versus optional) are defined in the contract and any

changes to the increase the periodic payment schedule, decrease the minimum and increase the maximum may be made by the company if it improves the customers contractual restrictions.

A **Single Premium Annuity** is what its name implies…a single lump sum paid to an insurance company into an annuity. The annuity contract owner will then let the company know when they want the payments to begin and under what payment option they want it to be paid out.

- **Single Premium Immediate Annuity (SPIA)** — The single premium immediate annuity is funded with a single lump-sum payment. By paying in a lump sum of money the annuitant is guaranteed to receive a series of payments over a period of time. The amount of the payment is determined by both the current interest rate at the time the contract is issued and by choices made from a wide variety of payment options. Once the annuity contract is issued, the payments are fully guaranteed for the period of time chosen. With a single payment immediate annuity, the accumulation period is eliminated. After the purchase of the annuity, the annuitant goes directly into the annuity period.

If after-tax funds are used to purchase a single premium immediate annuity, the income payments received are only partially taxable. The nontaxable portion of each payment is a level percentage that represents the return of principal over the life of the contract. Depending on their age and the payment option chosen, this percentage will vary. If they are using tax-qualified funds (IRA, TSA, 401(k) money, for example) to purchase their single premium immediate annuity, the payments they receive are generally fully taxable as received because they represent funds that have not previously been taxed.

- **Single Premium Deferred Annuity (SPDA)** — As is obvious from its name, a single premium annuity is typically funded with a single lump sum payment. Usually, that is relatively large—but it does not have to be. Insurance companies require minimum premiums for this type of contract and they may range from a few thousand dollars to much larger amounts. The money placed in a single premium deferred annuity (SPDA) is left to accumulate for the future. When the desired income is needed, the contract can be annuitized (begin payout).

An SPIA differs from a Single Premium Deferred Annuity (SPDA) in the respect that the income stream provided by the SPIA is available immediately after making the annuity purchase, whereas the SPDA provides payments at a later date in time.

- A **Flexible Premium Annuity** is also what its name applies…varying amounts of payments and varying time intervals between payments. All amounts at those intervals accumulate to build a fund to be available for payments in the future at the direction of the annuitant/owner in line with the various payout options provided by the contract. With the flexible premium method, the purchaser has the option to vary the amount of each premium payment, as long as it falls between contract-specified minimum and maximum amounts.

- **Periodic Payment Deferred Annuity** — The Periodic Payment Deferred Annuity is basically the same as the Single Premium Deferred Annuity (SPDA), however it is funded with periodic payments on a scheduled basis (monthly, quarterly, semi-annually, or annually) rather than one lump sum payment. Payout occurs at a scheduled future date.

- **Flexible Premium Payment method** — This is where the purchaser has the option to vary the amount of each premium payment, as long as it falls between specified amounts.

No matter which type of annuity the consumer chooses, annuities guarantee an income, no matter how long life continues. The annuity contract defines guidelines pertaining to additional investing, withdrawals, cancellations, penalties, and guarantees.

PARTIES TO THE ANNUITY CONTRACT

There are more parties involved in the annuity contract besides the insurance company and the contract owner. The annuitant and the beneficiary are added to the equation—even a contingent annuitant can be named.

THE ISSUING INSURANCE COMPANY

It is the insurance company who issues the annuity contract and, in doing so, assumes a number of financial obligations to the owner, the annuitant, and the beneficiary. In a very general sense, the insurance company that issues an annuity contract promises to invest the owner's premium payments responsibly, credit interest to the funds placed in the annuity, and pay the settlement option selected by the contract owner.

THE CONTRACT OWNER

Every contract must have an owner, even annuities. The owner is someone who has decided to purchase the annuity as part of a financial plan for retirement or for some other purpose. The contract owner can be a real flesh-and-blood person—the owner can also be a couple, a partnership, a trust or even a corporation. The contract owner typically holds all rights under the contract.

The contract owner has the right to choose and manage the investment options. He/she can add funds to the annuity, withdraw any portion of the funds in the annuity, change parties to the contract, will any or all portions of the contract, and terminate the contract. It is the owner of the annuity who names the individual who will serve as the annuitant as well as the individual or entity who will be the beneficiary under the contract.

The contract owner may elect to perform any of the following:

- Assign the old annuity contract (if premiums are nonqualified) to the new insurance company;
- Exchange the entire annuity (cannot transfer some of the money):
    - If there are loans outstanding, repay loans before exchanging;
    - Designate and change designations of annuitant and/or beneficiary.

If an exchange is implemented, parties designated in the old contract as owner, annuitant and/or beneficiary should again be designated in the new contract. Consumers should consult with their tax advisor before initiating an exchange.

THE ANNUITANT

The annuitant is the individual named under the annuity contract whose age is used to calculate payments. He/she may or may not be the person who receives the payment at payout. Since the annuitant is the individual whose life is of primary importance in affecting the timing or amount of the payout under the contract, it seems obvious that the annuitant be a “real person.” Although it is the most common arrangement, there is no requirement that the owner of the annuity contract and the annuitant be the same individual.

In addition, though the contract owner has the option of changing the annuitant at any time, most annuities require the stipulation that the new annuitant was alive when the original contract was executed.

An annuitant is like the insured in a life policy; however, the annuitant cannot control the contract, make withdrawals, make deposits, change the parties to the contract, or terminate the contract.

THE BENEFICIARY

Similar to the beneficiary of a life insurance policy, the annuity contract beneficiary receives the contract's death benefit when the annuitant dies. The beneficiary can be a family member, a friend, or even a trust, a corporation, or a partnership. The annuity contract even permits multiple beneficiary designations—all at the direction of the contract owner. For instance, a beneficiary designation may state that the contract owner's spouse receive 75% of the annuity contract value, and the contract owner's child receive the remaining 25%.

DESIGNATING MULTIPLE PARTIES

The contract owner has the option of assigning multiple titles to him/herself, the annuitant, or the beneficiary. If the contract owner designates a living trust or a corporation as beneficiary, the corporation or trust may only be the contract owner and/or beneficiary. The annuitant must be a living individual meeting the insurer's age restrictions.

AGE LIMITS FOR THE OWNER AND ANNUITANT

Most annuity contracts have minimum and maximum age limits for the owner and the annuitant. Since the beneficiary is the one receiving the proceeds of the annuity at death and the contract is terminated at the payout, there are no age limits on the beneficiary. The minimum and maximum age is used to determine the minimum age at which an annuity contract may be issued and the maximum age that the annuity contract may be issued. Some annuity contracts state the minimum and maximum age of both the owner of the annuity contract and the annuitant. Typically, the minimum age is 0+, but in some cases it is 18.

Maximum age depends on the insurer. For maximum payout ages, there is no age maximum required by the IRS, but most companies set their own maximum age for annuitization at 80 to 85, while others allow a maximum age of 100. Contract purchasers should check the contract for these requirements before purchase, especially if they desire to annuitize the contract at an older age.

There are two methods used to establish the insurance age of the insured. The insurance age is not necessarily the actual age. Some companies use the age of the

insured's last birthday to determine the insurance age. This method is the most commonly used method.

Some companies use the rounding off method. If the insured's next birthday is over six months away, then the age of the individual's last birthday is used to establish the insurance age. However, if the insured's next birthday is less than six months away, then the age of the individual's next birthday is used to establish the insurance age.

Even though two people may turn the same age within the same year, it does not mean that their insurance age is the same. The following table provides an example.

Insured	Policy Date	Birthdate	True Age	Insured Age	Premium
Ralph	August 1	January 5 (less than 6 mos.)	30	31	$100
Martha	August 1	March 4 (more than 6 mos.)	30	30	$85

Table 2.1

THE THREE PHASES OF THE ANNUITY

There are three basic phases in the life of an annuity...Contribution, Accumulation, and Distribution.

Contribution refers to the methods, timing, and amounts of money set aside in the annuity policy. Contributions can be a lump sum as well as periodic payments over time. The threshold of entry is not limited to people of wealth, but many can put aside money for as little as $50 or less on a monthly basis.

Accumulation is the time between the contributions and the distribution (payout) period. During this period the annuity builds up and accumulates the funds that will provide the annuitant with the total funds that generate the income stream desired during the distribution phase. The growth during this period is tax deferred and thus allows funds to grow unencumbered and much larger by current income taxation not being applied.

Distribution (annuitization) refers to the period when the insurance company provides the annuity payments over a specific period of time, or over the annuitant's lifetime.

ANNUITY ACCUMULATION PERIOD

The accumulation period is the interval of time from the contract's date of issue to the annuity date or surrender of the contract. All annuities have an accumulation period (or accumulation phase), which becomes effective the moment investments are selected. In the fixed annuity, **interest** is credited during the accumulation period. In the variable annuity, **investment results** are credited.

During the accumulation phase, you make purchase payments, which you can allocate to a number of investment options. For example, you could designate 40% of your purchase payments to a bond fund, 40% to a U.S. stock fund, and 20% to an international stock fund. The money you have allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, variable annuities often allow you to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum; e.g., three percent (3%) per year.

Example:

Susan purchased a variable annuity with an initial purchase payment of $10,000. She allocated 50% of that purchase payment ($5,000) to a bond fund, and 50% ($5,000) to a stock fund. Over the following year, the stock fund had a 10% return, and the bond fund had a five percent (5%) return. At the end of the year, Susan's account had a value of $10,750 ($5,500 in the stock fund and $5,250 in the bond fund), minus applicable fees and charges of course.

DEFERRED ANNUITY ACCUMULATION PERIOD

In a deferred annuity, the contract owner pays money into the annuity, which is accrued at interest over a period of years. Thus, the payments are deferred for a number of years. While the money is being accumulated, the deferred annuity has tax advantages as the interest credited to the funds is deferred from current taxation. Thus, income tax is not owed until the annuitant starts receiving payouts or distributions from the annuity.

The greater the contributions, the longer the accumulation period, the greater the income stream

The greater the contributions are during the accumulation period and the longer the accumulation period is, the greater the income stream when payout begins.

FIXED ANNUITY ACCUMULATION PERIOD

Every fixed annuity policy contains an underlying guaranteed minimum credited interest rate. The minimum interest rate during the accumulation period may be different than the minimum interest rate during the payout period. In addition to the guaranteed underlying interest crediting rate, the annuity company usually declares a current interest rate that is higher than the minimum guaranteed rate and it is normally guaranteed for a period of time, generally one year. At the end of this period the company will declare a new current credited rate.

VARIABLE ANNUITY ACCUMULATION PERIOD

As you already know, variable annuities fluctuate in value according to the performance of its underlying investments, which are held by the company in a separate account outside their general accounts. During the accumulation period of a variable annuity all premium payments can be invested in either a fixed account or subaccounts or both. The fixed account earns a guaranteed rate of interest and the principal is also guaranteed and not subject to market fluctuations. Premiums invested in the subaccounts have the opportunity to participate in the growth of the stock market; however, the funds are subject to market risk.

ANNUITY PAYOUT PERIOD

The payout period is the time of annuitization—it is when the annuity contract's benefits are disbursed, usually at retirement. Just as annuities come with a variety of

features, they also come with a variety of payout options. The payout period can provide a guaranteed amount for a guaranteed period of time.

Annuitants with varied long-term income stream needs may tailor their income schedule to suit their particular needs—monthly, quarterly, semiannually, or annually. At the beginning of the payout phase, you may receive your purchase payments plus investment income and gains (if any) as a lump sum payment, or you may choose to receive them as a stream of payments at regular intervals (generally monthly).

If you choose to receive a stream of payments, you may have a number of choices of how long the payments will last. Under most annuity contracts, you can choose to have your annuity payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of you and your spouse or other beneficiary). During the payout phase, your annuity contract may permit you to choose between receiving payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that selected for receiving payments. Be aware that some annuities do not allow you to withdraw money from your account once you have started receiving regular annuity payments.

ANNUITIZATION DATE

The annuitization date is the date at which the annuitant begins to receive annuity payments. This date is the earlier of two dates: the maturity date or the optional date elected by the contract owner. The maturity date is the latest date to which annuity payout options can be deferred and is stated in the contract. Many contracts stipulate that the owner may change the maturity date, and the new maturity date may be the last day of the term, but may be no later than the maximum age stated in the contract. The maturity date is often misunderstood. The maturity date is typically the LAST date by which the client must take receipt of the proceeds, not the first date on which they may do so without surrender penalties.

ANNUITY DEATH BENEFIT OPTIONS

Most annuities have a death benefit that will be paid to the annuity beneficiary if the annuitant dies before annuitization begins. Once annuitization has begun, the annuitization option will determine what amounts (if any) flow to the beneficiary when the annuitant dies.

The value of an annuity will not be included when the gross estate is valued for probate purposes. In essence, as long as an individual is the named beneficiary (i.e., any person and not an estate or other entity), probate can be avoided.

If a premature death should occur, the accumulated funds within the annuity may be transferred to the named beneficiaries, thereby avoiding the expense, delay, frustration and publicity of the probate process. Like most assets, the annuity is part of the taxable estate. The heirs can choose to receive a lump sum payment or a guaranteed monthly income.

TRADITIONAL FIXED ANNUITY/FIXED INDEXED ANNUITY DEATH BENEFIT

With a **traditional fixed annuity**, the death benefit (prior to annuitization) usually pays the beneficiary an amount equal to total contributions to the annuity, less any withdrawals or loans made during the annuitant's lifetime and plus the guaranteed interest or actual interest credited.

While each **fixed indexed annuity** can vary in the wording of the death benefit, they generally follow the formula below. If the annuitant dies during an index period, and there have been no partial withdrawals, the designated beneficiaries usually receive the greater of:

- The total of premiums paid;
- The surrender value on the date of death; or
- The indexed value on the most recent anniversary date.

If the annuitant were to happen to die on the day the index period ends, the designated beneficiaries receive the surrender value. Upon death, the proceeds may be distributed in a lump sum or in level amounts—these payments may be made over a certain period of time or during the lifetime of each beneficiary.

VARIABLE ANNUITY DEATH BENEFIT

Upon the death of the annuitant, the variable annuity provides that the beneficiary will receive the greater of the principal plus any ongoing additions, or the value of the account on the date of death. An older person desiring a high income stream will find the variable annuity guaranteed death benefit an ideal investment. It is based on the sum of all investments made by the owner or value on the date of death, whichever is greater.

The guaranteed death benefit will last until either:

- The annuitant terminates the contract;
- The annuitant annuitizes the investment;
- The annuitant dies; or
- The annuitant reaches a certain age, usually 75 or 80.

REQUIRED MINIMUM DISTRIBUTIONS

Required minimum distributions (RMDs) generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 72 (70½ if you reach 70½ before January 1, 2020), if later, the year in which he or she retires. However, if the retirement plan account is an IRA or the account owner is a five percent (5%) owner of the business sponsoring the retirement plan, the required minimum distributions must begin once the account holder is age 72 (70½ if the annuitant reaches age 70½ before January 1, 2020), regardless of whether he or she is retired. In future years they are required to make a withdrawal by the end of the calendar year.

If the account owner fails to withdraw the required minimum distribution, fails to withdraw the full amount of the required minimum distribution, or fails to withdraw the required minimum distribution by the applicable deadline, the amount not withdrawn is taxed at 50%.

The penalty may be waived if the account owner establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall. If order to qualify for this relief, the recipient must file Form 5329 and attach a letter of explanation.

Distributions taken in excess of the required minimum distribution for one year cannot be applied to the required minimum distribution for any future year.

RETIREMENT PLANS COVERED

According to the IRS, required minimum distribution rules apply to the following kinds of retirement accounts.

- SARSEP IRAs
- SEP IRAs
- SIMPLE IRAs

- 401(k) plans
- 403(b) plans
- 457(b)plans
- Profit sharing plans
- Other defined contribution plans

The required minimum distribution rule does not apply to Roth IRAs, as they are funded with money on which taxes have previously been paid. Withdrawals from Roth IRAs are not required until the owner dies. Roth 401(k) accounts, however, are subject to required minimum distribution rules.

MULTIPLE RETIREMENT PLANS

If they have more than one retirement plan from which required minimum distributions must be made, they must calculate the amount required for each plan. The actual minimum distribution may be taken from one plan to satisfy the required minimum distribution. The value used to calculate the required minimum distribution is the total value of each plan as of December 31st of the preceding year.

CALCULATING THE REQUIRED MINIMUM DISTRIBUTION

Calculating the MRD is easy. Take the account balance as of December 31 of the preceding year and divide it by their appropriate life expectancy. The IRS publishes life expectancy tables, and the recipient must choose the life expectancy table based on their particular situation.

- **Joint and Last Survivor Table** — Use this if the sole beneficiary of the account is a spouse and that spouse is more than ten years younger.
- **Uniform Lifetime Table** — Use this if the spouse is not the sole beneficiary or the spouse is not more than ten years younger (see chart below).
- **Single Life Expectancy Table** — Use this if you are a beneficiary of an account (an inherited IRA).

Contributions include all contributions made in the immediate preceding year for which the calculation is made. When calculating the distribution for the second year only, it is reduced by any distribution made in that year to satisfy the required minimum distribution for the first year.

To estimate the amount of the required minimum distribution from an account in a given year, take the balance as of December 31 of the previous year and divide it by the distribution period, or life expectancy, corresponding with the age on the following IRS table.

Table III (Uniform Lifetime)			
Age	**Distribution Period**	**Age**	**Distribution Period**
70	**27.4**	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	**100**	**6.3**
78	20.3	101	5.9
79	19.5	102	5.5
80	**18.7**	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.48	108	3.7
86	14.1	109	3.4
87	13.4	**110**	**3.1**
88	12.7	111	2.9
89	12.0	112	2.6
90	**11.4**	113	2.4
91	10.8	114	2.1
92	10.2	**115 and over**	**1.9**

Table 2.2 [4]

[4] irs.gov/pub/irs-tege/uniform_rmd_wksht

Example:

Henry is 72 years old and has $210,000 in his IRA. He would divide $210,000 by 25.6 (the distribution period on the table corresponding with the age of 72) and arrive at $8,203.12. This is the amount he is required to withdraw.

If Henry has several accounts with required minimum distributions, he must calculate the required minimum distribution for each account. He may add up the required minimum distribution amounts and withdraw all the money from one account or any combination of relevant accounts.

This method of calculation applies in all cases, except when the spouse is the sole beneficiary of an IRA and is more than ten years younger than the account holder. The IRS provides a different IRS worksheet to use if the spouse is more than ten years younger and is the sole beneficiary.

THE SECURE ACT

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) became law on December 20, 2019. The purpose of the Act was to help Americans save for retirement and is being hailed as the most significant retirement legislation enacted in the past decade. It provides incentives to get more small businesses to offer retirements plans for their employees and to boost retirement savings generally.

The SECURE Act made major changes to the required minimum distribution rules. If you reached the age of 70½ in 2019 the prior rule applies, and you must take your first required minimum distribution by April 1, 2020. If you reach age 70½ in 2020 or later, you must take your first required minimum distribution by April 1 of the year after you reach 72.

For defined contribution plan participants, or IRA owners, who die after December 31, 2019, (with a delayed effective date for certain collectively bargained plans), the SECURE Act requires the entire balance of the participant's account be distributed within ten years. There is an exception for a surviving spouse, a child who has not reached the age of majority, a disabled or chronically ill person or a person not more than ten years younger than the employee or IRA account owner. The new 10-year rule applies regardless of whether the participant dies before, on, or after, the required beginning date, now age 72.

The required minimum distribution is the minimum amount that must be withdrawn from the account each year. Withdrawals must generally begin from an IRA, SEP

IRA, SIMPLE IRA, or retirement plan account when at the age of 72 (70½ if age 70 is reached before January 1, 2020). Roth IRAs do not require withdrawals until after the death of the owner.

- More than the minimum required amount may be withdrawn.
- Any withdrawals will be included in taxable income except for any part that was taxed before (the basis) or that can be received tax-free (such as qualified distributions from designated Roth accounts).

In addition to repealing the maximum age for required minimum distributions to age 72, following are key highlights of the Act.

- Repeals the maximum age for traditional IRA contributions, which was 70½
- Allows long-term, part-time workers to participate in 401(k)plans
- Offers more options for lifetime income strategies
- Permits parents to withdraw up to $5,000 from retirement accounts penalty-free within a year of birth or adoption for qualified expenses
- Allows parents to withdraw up to $10,000 from 529 plans to repay student loans
- Makes it easier for small businesses to offer 401(k) plans by providing tax credits and protections on collective Multiple Employer Plans (MEPs)
- Revised the Tax Cut and Job Acts that raised taxes on benefits for members of deceased veterans, as well as students and some Native Americans
- Automatic enrollment escalation allows new employees to be automatically enrolled in companies' qualified retirement plan and automatic annual escalation[5]

POOLED EMPLOYER PLANS

With the SECURE Act, small businesses will now be allowed to "pool" together to create larger qualified retirement plans for their employees. This is designed to help small companies afford to provide plans for their employees and to create potentially lower costs for employers and employees due to size and scope of plans.

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[5] LINRA, SECURE Act, https://www.limra.com/en/trending-topics/secure-act/; Forbes, Financial (In)Security: The Pros and Cons of the SECURE Act, Jan. 2020, https://www.forbes.com/sites/ericbrotman/2020/01/30/financial-insecurity-the-pros-and-cons-of-the-secure-act/#16567c034b8b

Automatic Enrollment Escalation

When new employees are enrolled in their company's qualified retirement plan, the plan sponsor is allowed to enroll an employee automatically with an initial contribution percentage and to escalate each employee's contribution percentage annually. Under the SECURE Act, the new escalation limit is 15%. Employees may choose to override this default setting, but since many employees don't bother to enroll or to update their plans regularly, this encourages good saving habits without creating required action or attention.

Tax Credit for Small Employers

In order to help small businesses provide retirement plans for their employees, the SECURE Act will provide a tax credit that covers up to $5,000 of plan costs for the first three years that the plan is in place.

In addition, the act will give a tax credit for employers who auto-enroll their employees in their plans.

Graduate School Compensation

Student aid paid to graduate or postdoctoral students is now deemed as "compensation" for the purposes of determining IRA contribution amounts. The premise is that graduate students will benefit from starting their retirement savings earlier.

IRA Contributions

Workers over age 70½ will no longer be prohibited from contributing to traditional IRA accounts. People are working longer than ever and in many cases are presumably doing so because they haven't reached financial independence. Allowing IRA contributions past that age is intended to be an incentive to keep saving for retirement beyond 70½.

Credit Card Loans on Defined Contribution Plans

The SECURE Act is making the funds in retirement plans more difficult to access by no longer allowing participants to borrow money from their plans through credit and debit cards. This is intended to help participants avoid debt and protect them from derailing their own retirement plans.

Portability of Annuity Contracts

This allows annuity contracts to be moved from one qualified retirement plan to another if the original plan no longer authorizes the specific contract. This is intended to help some plan participants to avoid high fees or penalties created when a plan sponsor changes underlying investment options.

Plan Eligibility for Part-Time Workers

Beginning in 2021, employees working between 500-1,000 hours a year for three consecutive years will be eligible to enroll in their employers' retirement plans, with the caveat that the employer won't be required to match the contributions. This will benefit long-term, part-time workers by granting them access to tax-favored retirement savings comparable to their full-time colleagues, and won't be expensive or operationally burdensome for employers.

Expansion of 529 Plans to Apprenticeships and Loan Repayments

The SECURE Act allows families to take tax-free 529 plan distributions for student loan repayment. Principal and interest payments toward a qualified education loan will now be considered qualified 529 plan expenses.

With so many families starting to explore alternatives to traditional college for their children, this is a way to help make sure that 529 plans are useful for as many people as possible. Student loans are such a huge problem for young graduates, and allowing 529 funds to be used for repayment is a welcome sight for many.

Disclosure of Account Balance as an Annuity Stream

The Act requires plan sponsors to provide estimates and illustrations for participants that show hypothetical outcomes of converting their defined contribution account balances into lifetime annuity payments.

Modifications to Stretch IRAs

This provision eliminates the ability for non-spousal beneficiaries of IRAs and retirement plans to "stretch" the required distributions over their lifetimes and will instead require all funds to be withdrawn within ten years of the death of the participant.

SAFE HARBOR FOR SELECTION OF ANNUITY PROVIDER

Employers will now be required to engage in (and periodically repeat) an "objective, thorough, and analytical search" of annuity providers, including the annuity provider's capability of making payments to participants, plan features and costs, licensure status of insurers and state insurance commissioner requirements.

STRUCTURED SETTLEMENTS

From time to time, you may encounter a person who received, or is about to receive, a large settlement from a personal injury lawsuit.

A structured settlement is an arrangement in which the injured party (plaintiff) agrees to accept a series of periodic payments either over a lifetime or for a fixed number of years rather than pursue a lump sum settlement. The desirability of the arrangement is obvious when the injured party is a child or otherwise incompetent to manage a large lump sum, but many competent adults also accept a structured settlement because of income tax considerations.

TAX ADVANTAGES OF A STRUCTURED SETTLEMENT

Let's look at an example to illustrate the tax advantages of a structured settlement.

Assume Susan receives $1 million as a lump sum settlement for personal injuries. The $1 million itself is tax-free under the IRS Code, but Susan wants to invest in order to provide an income to live on. Suppose she buys an investment that produces an eight percent (8%) return, or $80,000 per year. Depending upon where Susan lives, the combined local, state, and federal income tax on her annual income could be in the 30% to 40% range. On the other hand, if Susan had agreed to accept a properly arranged structured settlement of, say, $100,000 per year for life, the entire amount received is income tax free under Code section 104(a)(2), according to Revenue Ruling 79-220, 1979-2 C.B. 74.

A NEGOTIATED SETTLEMENT

A structured settlement is arranged through negotiations between the injured party and the defendant, or more likely, the defendant's casualty insurer. (It's important to note the desired tax effects aren't available if the plaintiff has either actual receipt or constructive receipt of a lump sum. If the plaintiff has the settlement check in hand, there is no doubt actual receipt has occurred).

Constructive receipt occurs either when a plaintiff has the money available or when it is set aside for them. Thus, if the plaintiff is offered the choice of a lump sum settlement or a structured settlement, the IRS may take the position the plaintiff had constructive receipt of the money. If the defendant's casualty insurer agrees to make periodic payments to the plaintiff, it could buy an annuity to fund the payments, but it would have to be the owner of the annuity. Under no circumstances can the plaintiff be the owner of the annuity without triggering the constructive receipt rule.

As a practical matter, casualty insurers won't buy an annuity and make periodic payments themselves. First, the casualty insurer desires to "close the books" on claims and doesn't want to keep a file open for years to come. Secondly, the company can't deduct the premium cost of the annuity in the year of purchase; instead, the company must amortize the cost of the structured settlement over the term of the annuity, and deduct the payments when made to the plaintiff.

QUALIFIED ASSIGNMENTS

In reality, structured settlements are carried out through the use of a **qualified assignment**. An assignee, typically an affiliate or subsidiary of a life insurance company, assumes the obligation of the casualty company to make periodic payments to the plaintiff, and in consideration receives a single premium payment from the casualty company. The plaintiff agrees to release the casualty company from liability and looks solely to the assignee for periodic payments. The casualty company then deducts the entire premium payment in the year made as a business expense and clears its books. This arrangement is what is meant when the terms structured settlement contract or structured settlement annuity are used.

An agent can't expect to sell an ordinary deferred annuity to either the plaintiff or casualty company as part of a structured settlement. In order to make a commission, an agent must be licensed with a structured settlement company and sell that company's contract to the casualty company to cover a settlement previously negotiated with the plaintiff.

Of course, if the plaintiff has a lump sum settlement check in hand, the agent may sell a deferred annuity to them, but they must be made aware that distributions will be subject to the usual annuity taxation rules, including the 10% penalty for withdrawals prior to age 59½.

Utilize a qualified assignment to avoid constructive receipt

VARIOUS SETTLEMENT OPTIONS

Settlement of the policy takes place when benefits are paid to the annuitant, contract owner, or beneficiary(ies). The distribution phase of annuities is the fundamental purpose for which the annuity vehicle holds its uniqueness over all other saving and investment vehicles. There are many options, methods, and techniques in this area that provide alternatives to best match the annuitant's needs.

At one time these insurance policy proceeds were only paid by a lump sum method; however, this may cause some problems for the beneficiary if they are incapable of handling the responsibility of such a windfall. Regardless of the type of annuity, once the amount of the death benefit has been determined, the beneficiary has a choice of settlement options. First, let's define the various structured settlement options.

- **Payment Schedule** — The annuity recipient can receive payments at regular intervals, such as monthly, quarterly, annually or even some combination of schedules.
- **Increasing Payments** — Payments can be adjusted upward over time to keep in step with inflation. Payments can also be scheduled to rise even faster in some cases.
- **Decreasing Payments** — Payments can be designed to start at a high rate and then decrease. This type of payment option is typically applied when certain temporary costs have risen, but are expected to decrease in time.
- **Initial Lump Sum** — In many structured settlement annuities, periodic payments are supplemented by a larger lump sum payment that comes immediately after the settlement is agreed.
- **Final Lump Sum** — An annuity can also be designed to have a large lump sum payment at the end. This type of payment option would be useful if a smaller amount is needed for a certain period, and a larger amount as the last payment for a larger expense (such as college tuition).
- **Periodic Lump Sums** — Special extra payments may be paid in addition to less frequent normal payments. This type of payment option is typically useful

for someone who has a need for a larger payout every few years for certain larger expenses.

If the beneficiary is a spouse of the annuitant, they often have the option to “assume” the annuity and continue as if they had always been the named annuitant. The beneficiary usually has the choice of taking the death benefit in a lump sum or receiving the death benefit amount under one of the annuity settlement options.

While settlement options are not required by law, most policies have them. Some of the options available are lump sum, fixed installments, proceeds plus interest, life income, joint life income, or another mutually agreed upon method.

The annuity income schedule can actually be tailored to suit the contract owner’s needs. They can choose to receive payments, monthly, quarterly, semi-annually or annually.

When the policyholder is ready to start receiving payouts from an annuity (immediately with immediate payout annuities or deferred to a later date with deferred annuities), the accumulated value of the annuity will fund the benefit payments. The payout settlement option provision in an annuity contract describes the available payout options.

The following takes a look at many of the payment options available. All options have advantages and disadvantages.

Period Certain Only — Period certain (certain period of time) means that income payments will be made over the number of years the annuitant chooses. Payments will continue for the duration of the number of years chosen, and then cease. If they should die before the end of the stated number of years, the contract’s beneficiary would continue to receive the payments for the remainder of those years. When the period certain ends, so do the payments.

Most annuity contracts only allow annuitization over a limited choice of certain periods (e.g., 3 yrs., 5 yrs., 10 yrs., etc.); however, some annuity contracts allow the annuity owner to specify a dollar amount of the periodic annuity payment and then “back in” to the length of the period certain.

- **Advantages** – Usually provides a larger income stream than any of the life assumption options; Exceptions would be if period certain was longer than life expectancy of annuitant; Amount of income needed is driver for the options and the amount paid under period certain meets short-term income goals better than a life assumption option.

- **Disadvantages** – No life assumption, therefore annuitant and/or spouse could outlive income stream.

Amount Certain — With the Amount Certain option, the insurer pays a fixed benefit amount for as long as the accumulated value of the annuity lasts. The Life with Amount Certain option provides for monthly income payments to be made throughout the life of the annuitant and continues to the beneficiary until the total payments equal the amount paid for the annuity.

- **Advantage** – As with fixed period and fixed amount if you live the period selected or until the installments run out.

- **Disadvantage** – If you die early, the beneficiary does not receive any left over amount.

Life Only — The life only option provides for payments that continue throughout the life of the annuitant; the annuitant cannot outlive income. Upon the annuitant's death, however, payments cease, regardless of the length of time payments have been made.

- **Advantages** – Results in the highest payout among the life assumptions; Provides an income stream for the life of the annuitant.

- **Disadvantages** – Does not offer a refund or guarantee to the heirs if the annuitant dies before receiving all of the initial premium back; No income stream to spouse if married.

Life and Period Certain — Life and period certain means that payments will continue for the annuitant's lifetime, but for no less than the number of years stated in the contract. If the annuitant should die before the end of the stated number of years, the contract beneficiary would continue to receive the payments for the remainder of those years.

- **Advantages** – Provides an income stream for life; The period certain guarantee supports a larger amount to the heirs than the refund or guaranteed minimum should the annuitant die early; Also potentially would provide a benefit to the heirs when the refund wouldn't.

- **Disadvantages** – Pays smaller income amount to the annuitant due to the increased costs of the period certain guarantee; No lifetime income stream to spouse if married; If you die early, your spouse will only receive the balance of the remaining payments and will forfeit the rest to the insurance company.

Life Only with Guaranteed Minimum Option — The annuitant receives payments that will continue for the rest of their life. If the annuitant should die before they have been repaid the contract's initial investment, the balance of the initial investment will be paid in like installments to the contract's beneficiary.

- **Advantages** – Guarantees that if the annuitant dies before receiving at least their initial investment in the annuity, the heirs will receive the balance; Provides an income stream for life.

- **Disadvantages** – Pays a smaller income to the annuitant than life only due to the cost of the minimum guarantee to the heirs; No income stream to spouse if married.

Joint and Survivor — This option provides payments that are guaranteed during the lifetime of two people (usually spouses). After the death of one, payments continue for the lifetime of the surviving person. The annuitant can choose to have either full payments, or a percentage they chose to continue for the lifetime of the survivor. They can also specify a period certain, and if both individuals were to die within the period certain, payments would continue to the named beneficiary for the remainder of the period certain.

Life Annuity without Refund — The insurer pays a monthly income to the payee for as long as the annuitant lives. No payments will be made after the death of the annuitant.

- **Advantage** – Larger payouts.

- **Disadvantage** – If you die before the account value is spent, the insurer gets the rest of the money.

Joint and 50% Survivorship — The insurance company pays a monthly income to the payee while both annuitants are living. When the primary annuitant dies, the monthly income will be reduced to 50% of the original income. No payments will be made after the deaths of both annuitants.

Joint and 2/3 Survivorship— The insurance company pays a monthly income to the payee for as long as either annuitant lives. When the first annuitant dies, the monthly income will be reduced to 2/3rds of the original monthly income. No payments will be made after the death of the surviving annuitant.

- **Advantages** – Provides an income stream for life of annuitant and/or spouse; Most companies allow a reduced survivor benefit (as in the 2/3 example above) to minimize impact on income while both live.

- **Disadvantages** – Pays a smaller income amount than would any of the other life assumption options; If spouse predeceases annuitant, annuitant is stuck at lower income level.

Joint and Survivor Annuity with Period Certain — This is a variation on the life income with period certain. The insurer pays a monthly income to the payee for as long as either annuitant lives. When either or both of the annuitants die before the payee has received all period payments, the company will continue to pay the monthly income to the payee for the rest of the payments.

For more flexibility, some contracts allow for systematic withdrawals. In this case, the contract would pay a fixed percentage of the account value or a fixed monthly amount. This arrangement can be stopped at any time and the remaining balance withdrawn. Although systematic or extended payout may have advantages over annuitization, note these two differences.

- With annuitization as the annuity settlement option, a guaranteed monthly income is guaranteed regardless of the performance of the annuity.
- In addition, annuitization lengthens the tax deferral period since only part of each payment is taxed. The IRS considers the other part of the payments as a return of principal.

ANNUITY EXPENSES AND FEES

The fees listed below are by no means an all-inclusive listing of fees insurance companies may charge for annuity purchases. As a general rule of thumb, the more complex a product is, the more one can expect to pay for it—the same is true with annuities.

Added bells and whistles = Additional fees

Fees are those charges for the cost of the various bells and whistles in annuity contracts.

SURRENDER CHARGES

In general, liquidity features are contained in annuity contracts. Depending upon the structure of the annuity, withdrawals of fixed dollar amounts may be made without penalty. However, the investor may incur surrender charges. In general, the surrender benefit is equal to the contract value less any surrender charges upon surrender of the contract.

Insurance companies vary in principal language (contract content relating to the principal) to protect the insurer, just as guarantee of principal protects the contract owner. In most annuities, surrender charges decrease over time, such as over a five- to ten-year period (10% free partial withdrawal not included). There may be an annual percentile decrease in surrender penalties, or the annuity may have a fixed surrender charge, such as the first six month's interest.

An example of a surrender charge schedule might look like the following.

Contract Year	Surrender/Withdrawal Charge
1	8%
2	7%
3	6%
4	5%
5	4%
6	3%
7	2%
8	1%
9	– ZERO –

Table 2.3

Charges are either based on "date of deposit" or "date of contract."

Deposits to the contract are not subject to a "load fee" or "front-end fee." However, withdrawals may be subject to a **contingent deferred sales charge** (CDSC) and are assessed on a sliding scale. Charges are either based on the date of deposit or the date of contract.

Fees and charges are imposed for some additional provisions in the annuity contract, such as stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance.

Most, if not all, annuity contracts that have surrender fees contain a **withdrawal provision**. This provision typically allows one to withdraw up to10% of the account value after the first year without incurring a surrender fee.

Similarly other companies allow for withdrawals of either the interest in the account or 10%, whichever is greater. And, still others allow the 10% withdrawal amounts to accumulate each year to allow for accumulated withdrawals of 20%, 30%, 40%, etc., as time passes.

Example:

Susan purchased a variable annuity contract with a $10,000 purchase payment. The contract has a schedule of surrender charges, beginning with a seven percent (7%) charge in the first year, and declining by one percent (1%) each year. In addition, she is allowed to withdraw 10% of the contract value each year free of surrender charges. Her contract value has not increased or decreased because of investment performance. In the first year, she decided to withdraw $5,000, or one-half of the contract value of $10,000. In this case, she could withdraw $1,000 (10% of contract value) free of surrender charges, but will have to pay a surrender charge of seven percent (7%), or $280, on the other $4,000 withdrawn.

ADMINISTRATIVE FEES

The most conventional fee charge for an annuity is the administrative fee (aka, contract fee). These fees cover the basic management of the annuity, including such things as recordkeeping and account services.

When a company calculates the interest for an annuity, they will subtract a specific predetermined percentage from the interest rate calculated and credit the account with the balance.

Generally, annuity contract owners will have to pay an annual fee to manage and administer the annuity. Typically, it’s about 0.30 percent (0.30%) of the value of the annuity contract. However, many companies charge a flat dollar amount, which may typically range from $20 to $100 per year.

In an annuity that is index-linked, the 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 is10%, the 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%). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

Variable annuities have administration fees and distribution costs. Many variable annuities charge a fee for administration expenses. These fees can range from .15 percent (0.15%) to .40 percent (.40%) of the total account value and these fees are in addition to other fees in the contract. Many companies charge a flat dollar amount as a contract fee. There are also subaccount fees, which include charges for the operation and management of the subaccount.

A few insurance companies have referred to these terms as administrative fees. However, this is a misnomer because it makes this adjustment approach sound similar to fees for variable annuities or mutual funds, which they are not. These fees are not to pay for administrative or investment services rendered but rather, like all adjustments, to provide the company a “lever” to balance the hedging budget with the cost of hedging or reduce the risks inherent in hedging.

Example:

Susan’s variable annuity charges administrative fees at an annual rate of 0.15% of account value. The average account value during the year is $50,000. She will pay $75 in administrative fees.

MORTALITY AND EXPENSE (M&E) FEES

Mortality and expense fees are charged by the insurance company as a means to back the death benefit. This fee represents a source of profit for the insurer as it is levied against the account balance each year and is used to fund the insurer’s overhead, commission, and set up costs as well as death benefit claims costs.

These fees are designed to guarantee that the cost of providing the annuity won’t change—even mortality risk or life expectancy changes. Typically, these fees range from 0.50 percent to two percent (0.50%-2%) of the contract value. The mortality and expense risk charge allows the insurance company to hedge the amount of risk they are taking. Even if the annuitant mortality risk or life expectancy changes, the annuity is designed to guarantee that the cost of providing the annuity won’t change for the contract owner.

This fee is described in the prospectus and can vary with net amount of risk throughout the life of the annuity.

Example:

Susan's variable annuity has a mortality and expense risk charge at an annual rate of 1.25 percent (1.25%) of account value. The average account value during the year is $20,000, so she will pay $250 in mortality and expense risk charges that year.

COMMISSIONS

As with the sale of most insurance products, the agent receives a commission for the sale. The insurance company may roll the commission into the contract rather than detail it in a specific fee schedule.

UNDERLYING FUND EXPENSES

Underlying fund expenses are charges that combine the fees and expenses imposed by the subaccounts that are the underlying investment options for the variable annuity. These choices carry a charge as an "investment management" fee. The charges for the operation and management of the subaccount typically range from .15 percent to 1.50 percent (0.15% to 1.5%) of assets.

ONGOING EXPENSES

The annual contract maintenance charge can never be increased during the life of the contract and usually are around $50. This charge is reported on the insurer's fourth quarter statement and deducted from the then current value of the annuity.

RIDERS

As with most riders on typical insurance products, additional coverages or guarantees come at a cost. Riders are the extra features on an annuity contract that provide the annuitant with additional guarantees or death benefits. Depending on the extent of the benefit, riders can cost 0.25 percent to one percent (0.25% to 1%) of the contract value per year.

OTHER FEES

Any other fees that might be imposed depend on the type of annuity and the insurance company. Some companies may charge a premium tax, which is what an

insurance company uses to offset any state or federal taxes they incur when selling the annuity. Some may tack on other miscellaneous fees, such as a redemption fee or transfer fee or underwriting fee or distribution fee—the list can be extensive.

BAILOUT CLAUSE OR ESCAPE CLAUSE

The bailout clause (aka escape clause) is a protection for the contract owner. Most insurers will waive surrender charges under certain circumstances (i.e., nursing home confinement, terminal illness diagnoses, death or disability). In addition, the agreement between the insurer and the contract owner can allow for utilization of the bailout clause if the interest rate decreases below a certain level, called the bailout rate.

Example:

An annuity contract contains a provision in which the bailout rate is set at one percent (1%) below the current rate being credited. In this case, if the interest rate declared is more than one percent below the current interest rate, the owner of the annuity could surrender the annuity and not have to pay any of the surrender charges that are normally charged for contract surrender.

This provides a measure of peace of mind for the annuity owner who wants to move their money in times of dramatically falling interest rates.

EARLY WITHDRAWAL PENALTY

Almost all annuities allow annuity owners to withdraw up to 10% of their account value before a surrender charge or withdrawal charge is applied. It is important that the consumer know how these charges apply before they buy an annuity contract to save themselves unnecessary expenses.

Most annuities offer a guaranteed interest rate for a period of time that is less than the number of years that the surrender charge applies. After the guaranteed interest period expires, the insurance company then declares the new interest rate for that policy year. When a person buys an annuity, they must be aware that the "renewal rate" will usually be lower than the initial guaranteed interest rate.

Tax advantages are extended for retirement purposes by the government. Tax advantages are also extended to the taxpayers who do not use the annuity for retirement. All interest withdrawn prior to the owner attaining the age of 59½ is subject to a 10% excise tax penalty.

There are **exceptions to the early withdrawal penalty**, however. The 10% excise tax penalty can be avoided under certain circumstances, such as the following:

- Taxpayer disability;
- Distribution from a pre-8/14/82 (pre-TEFRA) 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; or
- Substantially equal payments over the taxpayer's life expectancy.

TAX-DEFERRAL

A tax deferred annuity is a tax-advantaged product. An annuity contract provides income for a specified period of time, or for the duration of life for a person or persons. An annuity is an alternative to most other financial investments, in which long term financial needs are addressed.

"Tax deferred" means postponing taxes on interest earnings until a future point in time. In the meantime, interest is earned on the money the annuity is not paying in taxes. More money can be accumulated over a shorter period of time, which ultimately provides a greater income. All funds are tax-deferred until withdrawn. This enables the consumer to build a substantial fund for retirement and provide an income that cannot be outlived.

Many people today are using tax-deferred annuities as the foundation of their overall financial plan instead of certificates of deposit or savings accounts. Although CD's and annuities are very similar, there are significant differences between the two.

No taxes are payable while money is being compounded in the annuity. Money can grow faster in a deferred annuity than in a taxable investment with a similar interest rate. This is because earnings normally lost to taxes remain in the annuity and can generate additional earnings through the effects of compounding.

Tax deferral gives annuity owners control over an important expense—taxes! The annuity can generate a lower tax on random withdrawals because the tax year in which the withdrawals are made can be controlled. Taxes are only paid on the interest withdrawn—and anytime an expense can be controlled, it can be minimized. The longer this particular expense can be postponed, the greater the gain when compared to the gain that would be made with a fully taxable account.

Later, if a monthly income is paid, the taxes can be less because they will be spread out over a period of years. Like certificates of deposits, annuities incur a penalty for early surrender; however most annuity contracts have a liberal “free withdrawal” provision. And, if they wait until retirement to receive their annuity income, they may be in a lower tax bracket, adding to the value of the income they receive.

An annuity policy does not “mature” like a bond or certificate of deposit. Both principal and interest will automatically continue to earn interest until withdrawn or until the annuitant reaches age 100. They can let their money continue to grow, make withdrawals, or begin receiving an annuity income at any time.

The longer taxes can be postponed, the greater the gain!

To illustrate the increased earnings capacity of tax-deferred interest, let’s compare it to fully taxable earnings. $100,000 at 6.5 percent (6.5%) will earn $6,500 of interest in a year. A 28% tax bracket means that approximately $1,820 of those earnings will be lost in taxes, leaving only $4,680 to compound the next year. If these same earnings were tax-deferred, the full $6,500 would be available to earn even more interest. The longer you can postpone taxes, the greater the gain.

Tax Deferred vs. Fully Taxable		
	Certificate of Deposit	**Annuity**
Before-tax yield	6.5%	6.5%
After-tax yield	3.9%	6.5%
1 year	$103,900	$106,500
5 years	$121,081	$137,009
10 years	$146,607	$187,714
15 years	$177,514	$257,184
20 years	$214,937	$352,365

Table 2.4

…Now…Compare the Return!

$352,365 accumulated in a tax-deferred annuity
$214,937 accumulated in a taxable account
The Difference: $138,428

Table 2.5

NO MORE 1099'S

There is no withholding tax while an annuity is compounding; it is completely tax-deferred. If the owner requests a distribution (random withdrawals or annuity income), taxes will be withheld—unless they elect differently. Their election not to withhold can be made at the time they make their request. Because the interest is tax-deferred, it is not necessary to issue a Form 1099 while their money is compounding. Only when their interest is distributed (withdrawal or annuity income) will a Form 1099 be sent which will reflect the amount of interest that is actually received.

INTEREST EARNINGS TAXATION

Even though a withdrawal of principal is tax-free and free from penalty by the IRS, the government views that interest earnings come out first. And, should any portion of a withdrawal exceed interest earned, it would be a tax-free return on principal.

Depending upon the annuity purchased, withdrawals can be taxed in one of two ways. Prior to August 14, 1982, annuities were structured with FIFO accounting (first in, first out), which allowed the principal to remain tax-free. On August 14, 1982 and thereafter, annuity taxation changed to LIFO (last in, first out), which allowed for taxation on withdrawals since interest is withdrawn first. This is appealing to the consumer since most are now paying taxes on interest even if they don't withdraw it.

As long as the interest remains in the annuity contract, the investor pays no taxes on the interest earned. Therefore, the funds are working for the investor instead of being paid to the federal government in the form of taxes.

Typically, when the beneficiary receives the tax-deferred interest, he will be taxed on the monies collected. However, if the spouse of the deceased contract owner is the beneficiary, the beneficiary may decide, as the then customer, to continue the annuity and postpone taxes. If the deceased contract owner had named someone other than

his spouse as beneficiary, the monies must either be totally withdrawn within five years or be received over the beneficiary's life expectancy (this option must be elected during the first 12 months following the contract owner's death).

Section 1035(a) of the Internal Revenue Code provides a no-risk feature by allowing annuity owners to transfer funds from one annuity to another, thereby keeping the investment monies tax-free. Interest on many alternatives currently available is taxable every year.

Note: A personal tax advisor should always be consulted, as insurance agents are not trained or qualified to provide tax advice. The understanding of basic annuity taxation only allows an agent to help people accumulate more money, not provide tax advice.

SAFETY

A tax-deferred annuity is safe. A qualified legal reserve life insurance company is required to meet its contractual obligations to the owner. These reserves must, at all times, be equal to the withdrawal value of their 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. These reserves must be at all times, equal to the withdrawal value (principal plus interest less early withdrawal fees, if any) of every annuity policy. State insurance laws also require that a life insurance company must maintain certain minimum levels of capital and surplus, which provide additional policyholder protection.

PREMIUM COMPUTATION FACTORS

Insurance companies use multiple factors in determining the premiums.

- The annuitant's age will determine how long the company will have to make income payments to the annuitant.
- Statistics say that the annuitant's gender also plays a role. Statistics will show that women live longer than men. Therefore, a woman would receive more income payments than a man of the same age.
- An assumed interest rate as calculated by the insurance company.

- The next factor is the annuitant's amount of periodic income and the guarantees the insurance company made to the annuitant in regard to the total number of payments the annuitant will receive.
- The last factor is the "loading fee" charged for the insurance company's operating expenses.

DISADVANTAGES OF ANNUITY INVESTING

Although there are very few disadvantages with respect to investing in annuities, most of which will never affect the consumer, they should be fully understood.

TAXATION PENALTIES

All annuities are subject to IRS penalty regardless of annuity type. Withdrawals made prior to the annuitant attaining the age of 59½ years are subject to a 10% penalty. The exceptions to this rule are if the annuitant dies, becomes disabled, or takes a portion of the annuity's assets paid out as income on a regular basis (annuitization).

Monies accumulated are not tax-free; however, they can be deferred and can also be indefinitely postponed. Taxes can be further deferred by any of the following:

- The surviving spouse remarries;
- The surviving spouse is named as the annuitant and their new spouse is a beneficiary;
- When both spouses die, the beneficiary would be able to postpone taxes for up to an additional five years;
- The tax liability will be the value of the annuity at time of death less the amount invested and then multiplied by the beneficiary's tax bracket percentage.

The contract owner is wise to withdraw money from the annuity when in the lowest tax bracket.

INSURANCE COMPANY PENALTIES

Withdrawn funds of up to10% per year, after the first year, are usually not subject to penalty (varies by annuity). The surrender charge applies only when amounts are withdrawn in excess of the free withdrawal privilege. The insurer's penalty schedule should be investigated prior to purchasing an annuity, as terms vary.

Many annuities waive the surrender charges if the annuitant dies or becomes disabled; or if withdrawals are limited to those allowed under the free withdrawal privilege; or if systematic withdrawals of10% per year are made; or if the penalty period has lapsed.

INFLATION

Inflation may be the biggest threat to long-term investments. While a stock market crash may cause some temporary losses in the stock investments, markets always fluctuate and if stocks are kept long enough, it's possible not only to regain the loss, but also to make an eventual profit. Therefore, for the long-term, the investment must keep pace with inflation.

OPTIONS FOR WITHDRAWAL

Both fixed rate and variable annuities provide for withdrawal options, but any withdrawal may be subject to a penalty, or surrender charge. However, most insurance companies permit annuity withdrawals of up to10% (usually based on the principal) per year without cost, penalty, or fees. Some insurance companies will permit withdrawals of up to 15% per year. When considering withdrawal options, remember that the restrictions applying to withdrawals will eventually disappear and that an estimated 75% of all people investing in annuities never remove any money.

RISK OF LOSS

The annuitant faces several risks for loss of investment in a variable annuity.

Economic Risk — Risk due to the uncertainty of our economy, world affairs, conflicts, wars, recessions, depressions, or a total collapse of our economic system.

Rising Interest Rates — If an investor is "locked in" to a fixed interest rate and the economy is experiencing a period of rising interest rates.

Expenses — Variable annuity charges include load and management charges. These charges will reduce the value of an annuity account and the return on the investment.

Administrative Fees — The issuing insurance company usually charges an administrative fee and a mortality risk fee, usually about 1.25% of assets. This fee may be charged on an annual basis either as a flat account maintenance fee or as a percentage of the account value.

The **mortality and expense fee** represents a source of profit for the insurer as it is levied against the account balance each year and is used to fund the Insurer's overhead, commission, and set up costs as well as death benefit claims costs. Though the mortality charge is commonly 1.2%, it can range from 1.1% to as high as 1.5%. This fee is described in the prospectus and can vary with net amount of risk throughout the life of the annuity.

Contract Fees — Many companies charge a flat dollar amount as a contract fee. There are also subaccount fees, which include charges for the operation and management of the subaccount.

Underlying Fund Expenses — Underlying fund expenses are charges that combine the fees and expenses imposed by the subaccounts that are the underlying investment options for the variable annuity.

Ongoing Expenses — The annual contract maintenance charge can never be increased during the life of the contract and usually are around $50. This charge is reported on the insurer's fourth quarter statement and deducted from the then current value of the annuity.

Surrender Charges — Deposits to the contract are not subject to a "load fee" or "front-end fee." However, withdrawals may be subject to a **contingent deferred sales charge** (CDSC), a "back-end load" charge, and are assessed on a sliding scale. Charges are either based on the date of deposit or the date of contract.

Fees and charges are imposed for some additional provisions in the annuity contract, such as stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance.

- **Both fixed and variable annuities contain withdrawal options**
- **Withdrawals up to10% per year are permitted without penalty**

SUMMARY OF ANNUITY COMPARISON CHART

ANNUITY COMPARISON CHART

TYPES OF ANNUITIES		
Fixed	OR	**Variable**
Immediate • Single Premium	OR	**Deferred** • Single Premium • Level Premium • Flexible Premium
PAYOUT OPTIONS		
Life **Annuities** • Straight Life • Refund Life • Life with Period Certain • Joint Life • Joint and Survivor	OR	**Temporary Annuities** • For a designated period • For a designated amount

Table 2.6

Each type has their own advantages and disadvantages—and can fill individual personal needs dependent upon such variables as risk tolerance and income goals.

The market for annuities and large investments is very competitive. Several insurance companies should be compared. Consumers should check rates and specific payout intervals (i.e., five, ten, fifteen and twenty years) on the intended annuity investment amount. Then compare the differences in the returns on the investment.

IMPORTANT CHARACTERISTICS OF FIXED AND VARIABLE ANNUITIES

Some important shared characteristics of fixed and variable annuities are:

- Retirement income is the primary purpose;
- Purchase methods;
- Annuity options;
- Accumulation and annuity periods;
- Partial surrender provisions; and
- The guarantee of expense and mortality.

IMPORTANT DIFFERENCES BETWEEN FIXED AND VARIABLE ANNUITIES

Some important differences between fixed and variable annuities are:

- There is no guarantee of the principal, interest, or the amount of payment in variable annuities;
- The annuitant bears investment risks in variable annuities; and
- Variable annuities are regulated by the state and federal government.

PRINCIPAL GUARANTEE AND LOAN PROVISIONS

The owner is protected by a guaranteed value that must grow over time and result in return of principal within a short period of time. The owner is always assured of receiving at least these guaranteed values and more if credited excess interest raises then current value above guarantees. This is true because a true interest credit cannot be undone or lost in a fixed annuity. Thus, while the owner can not be sure of what future values will be (nor can the owner in an annually declared fixed interest rate approach) the owner does know guaranteed minimum values in advance and can use these to compare to other products, as well as whether the guaranteed minimum values approximate his or her minimum needs. Measured against a variable product or a mutual fund product, the owner is in a very different posture due to the guaranteed minimum values.

In summary, regardless of the specific product features by which an insurance company balances its assets and liability for interest credit, the owner is guaranteed the return of principal and a minimum rate of credited interest regardless of the insurance company's investment management skills. The insurance company accepts the risk, for example, that the Standard & Poor's 500 Index or the bond

market will perform well enough, and/or the company will manage its hedges well enough, to eliminate the insurance company's need to provide the guaranteed values.

Most qualified annuity contracts offer loan provisions (though some do not) to offset the IRS regulations concerning withdrawing money from an annuity. Some companies have accounts that do carry loan provisions and other accounts that do not have loan provisions. These loan provisions are highly regulated by the federal government; therefore, most are very similar. Some deviations exist in the amount of the money you can access and the interest rate you pay on money borrowed.

In general employees or owners of qualified individual annuities (IRA) are permitted to take one loan per a specified period (typically twelve months) Interest is typically charged and the loan must be repaid from within a specified timeframe (e.g., five or up to ten years). The loan is often required to be used to purchase a primary residence there are other, restricted uses like education and medical care. How much you can borrow depends on the amount currently in the account that the contract stipulates is available for loan. Often a maximum and a minimum loan amount is also stipulated. There are tax consequences if a loan is not repaid in accordance with the terms. If the loan is in default, it will be considered a "deemed distribution" and the outstanding loan balance (including accrued interest) will be reported to the Internal Revenue Service (IRS) as current taxable income, which may result in a substantial and immediate tax liability. In addition, if you are under 59½, the default may also be subject to an additional10% federal tax penalty for an early distribution.

ADVANTAGES AND DISADVANTAGES OF ANNUITIES

The National Association of Fixed Annuities (NAFA) believes that fixed indexed annuities are suitable for those with safe-money needs. Because of the variety of product and features choices someone wishing to protect some of their savings may benefit from a fixed indexed annuity regardless of age. And the advantages and disadvantages are measured on their financial objectives and their retirement needs.

There is a persistent misunderstanding on the suitability of fixed deferred annuities. Fixed deferred annuities offer lifetime guarantees and other benefits that set it apart from other financial products. The tax treatment of deferred annuities is different. If you understand these differences, you will see how these features are attractive to seniors, and more importantly, why fixed deferred annuities can be a suitable part of a senior's financial plan. Some of the features and benefits are explained below.

The ability to **elect an income that cannot be outlived at guaranteed rates** sometime in the distant future. This is a feature unique to annuities for those who require certainty in the income portion of their portfolio. Insurance companies are stepping up to the plate to fill a need, given their unique capability for insuring longevity risk. Moreover, in addition to specified guaranteed rates, the carriers also generally offer to turn the deferred annuity into an income stream at the customer's discretion guaranteed for a specific timeframe, even life, based on current factors that generally even more favorable than the guaranteed rates.

The **guarantees of fixed annuities** are the primary appeal to an older population, a dynamic that has been universally recognized across the financial services industry. Given their ability to safeguard and insure principal and previously credited returns, insurance companies are again in a unique position to meet the needs of seniors who are concerned about having their principal exposed to market risk. It is the convergence of this age group's need and the unique ability of insurance carriers that has created the substantial interest in fixed annuity products among seniors.

A secondary benefit of annuities is their **tax-deferred nature**. Accumulating and holding retirement funds in tax-deferred vehicles allows the asset to grow more quickly than would otherwise be the case in a similar, but taxable, vehicle. Due to this significant advantage, Congress has imposed a 10% penalty for taxable amounts withdrawn before age 59½ in recognition of the public good of holding these products into retirement years.

The tax treatment of deferred annuities lead to a significant proportion of owners over age 59½. Insurance companies have designed products in conformity with the tax laws and in response to the market demand for the product by those who have the most to gain from the benefits of these products.

While some casual observers may indicate that already-tax-favored funds such as IRA money and pension funds should not be held in an annuity because they are already tax favored and, therefore, there is no benefit to the use of annuity, they forget that it is the guarantees and longevity insurance that drive the use of the annuity in these situations.

Penalties for early withdrawal are common among financial products and annuities are no different. Still, **most annuities include a variety of withdrawal provisions, some of which provide substantial withdrawal rights without penalty**…and without exposure to loss of principal through market risk. Among the circumstances that commonly allow for early withdrawal of the entire proceeds without penalty are death, terminal illness, nursing home confinement, required minimum distributions and unemployment. Furthermore, most fixed annuities also allow for a specified

annual withdrawal amount without penalty. Most common is a 10% **of accumulated value penalty free annual withdrawal**, but other options may include interest (often cumulative) or a specified annual percentage amount that accumulates annually. No other accumulation vehicle allows the owner to make withdrawals prior to the end of the penalty period without penalty fees or market risk to the asset. Surrender penalties are clearly spelled out in the contract.

The maturity date of the contract is also commonly misunderstood. A **maturity date is a term of the contract required by state law and it is often the last date by which the funds must be dispersed.** This legal requirement also ensures that the annuity complies with federal tax laws. Generally surrender charges will be over before the maturity date is reached—in many cases long before the maturity date is reached. As indicated earlier, in most cases there is liquidity each year and in many cases the client is able to convert the proceeds to a stream of income before the maturity date without penalty.

In addition to tax-deferral, there is another significant **tax benefit to recipients of Social Security** benefits that causes the annuity to be particularly beneficial to older individuals. Social Security benefits can be taxed on up to 85% of the benefit amount at the client's marginal tax rate if their income is above a certain provisional level. This is true even if the income is left to accumulate in a vehicle such as a CD or is generally considered to be tax-free as with municipal bond interest. Not only do returns left to accumulate in a deferred annuity escape current taxation, they do not count in determining whether, and to what level, Social Security provisional benefits will be taxed. This is a significant benefit to customers, and especially middle class retirees who derive a significant percentage of their income from Social Security, not currently consuming all of their assets for living expenses.

Finally, because an annuity is a contract it generally passes to heirs through beneficiary provisions rather than through the probate process. For those without a will, this is one way in which assets can be passed to a named beneficiary **not subject to the intestacy provisions of the state and without the delays and costs associated with state probate.** Since the cost of probating assets for a decedent can be significant, again, especially for middle-class retirees, this is another benefit to a senior wise enough to have some of his or her assets in a fixed deferred annuity.

In the end, the two most important maxims for suitability are:

1. Target **safe money needs**, not age or demographic; and
2. Diversify products as well as risk by putting savings or investments into **more than one** financial product.

Suitability is always a matter for individual determination. Only a well-informed client can make an appropriate decision; therefore, it is important that all the features and benefits of the fixed annuity be fairly and accurately communicated to a prospective buyer.

ANNUITY INVESTING – PROS AND CONS

Annuity Investing	
Pros	**Cons**
• Regular payments • Contributions grow tax-deferred • Fixed annuities offer guaranteed returns • Variable annuities offer a death benefit	• High fees • Annuity growth might not match stock market growth • Getting out of an annuity may be impossible or very costly

Table 2.7

QUESTIONS THE CONSUMER MUST ASK AND THE AGENT MUST ANSWER

- Is this a single premium or multiple premium contract?
- Is this an equity-indexed annuity?
- What is the initial interest rate and how long is it guaranteed?
- Does the initial rate include a bonus rate and how much is the bonus?
- What is the guaranteed minimum interest rate?
- What renewal rate is the company crediting on annuity contracts of the same type that were issued last year?
- Are there withdrawal or surrender charges or penalties if I want to end my contract early and take out all of my money? How much are they?
- Can I get a partial withdrawal without paying surrender or other charges or losing interest?
- Does my annuity waive withdrawal charges for reasons such as death, confinement in a nursing home or terminal illness?

- Is there a market value adjustment (MVA) provision in my annuity?
- What other charges, if any, may be deducted from my premium or contract value?
- If I pick a shorter or longer payout period or surrender the annuity, will the accumulated value or the way interest is credited change? Is there a death benefit? How is it set? Can it change?
- What income payment options can I choose? Once I choose a payment option, can I change it?

KEY POINTS TO PONDER

- A deferred annuity is one under which the annuity owner defers or delays receiving payments until a later date.
- A fixed annuity provides a guaranteed fixed interest rate for a set period of time.
- The Internal Revenue Code drives federal taxation and individual states follow suit.
- Contributions made to a nonqualified annuity are not tax deductible.
- Qualified annuities are funded with pre-tax money, while nonqualified annuities are purchased with after-tax money.
- What makes an annuity "fixed" is that the insurance company promises that the money will earn a predetermined, "fixed return" per year for as long as the annuitant lives.
- If annuity funds are withdrawn in any method other than annuitization, taxes are paid on gain first (aka, the interest-first method of gain recognition) and the last monies withdrawn are the cost basis.
- If after-tax funds are used to purchase a single premium immediate annuity, the income payments received are only partially taxable.
- Qualified annuities are funded with pre-tax money; nonqualified annuities are funded with after-tax money.
- There are four parties to an annuity contract: the contract owner, the insurance company, the annuitant, and the beneficiary. However, they do not have to be four separate entities/persons as the annuity contract permits multiple designations.
- The contract owner has all rights to the contract, including changing the designated annuitant at anytime. Most insurance companies require that any new annuitant must have been alive when the original contract was executed. The contract owner may also designate multiple beneficiaries and can apportion the payout.
- An immediate annuity begins making annuity payments typically within one year of policy issuance.
- There are three basic phases in the life of an annuity contract: contribution, accumulation, and distribution.
- In a fixed annuity, interest is credited during the accumulation period. In the variable annuity, investment results are credited.

- In case of the contract owner's death, the value of an annuity will not be included when the gross estate is valued for probate purposes.
- In a traditional fixed annuity, the death benefit usually pays the beneficiary an amount equal to total contributions, less any withdrawals or loans. In a fixed indexed annuity if the annuitant dies during an index period, the beneficiary will receive the greater of the total premiums paid, or the surrender value on the date of death, or the indexed value on the most recent anniversary date.
- The RMD rule does not apply to Roth IRAs because they are funded with after-tax money. Roth IRAs do not require withdrawals until after the death of the owner. The Joint and Last Survivor life expectancy table is used if the sole beneficiary of the account is a spouse who is more than 10 years younger. The Single Life Expectancy table is used for beneficiaries of an inherited IRA.
- The SECURE Act changed the RMD age from 70½ to 72; requires the entire balance of a defined contribution plan to be distributed within 10 years, virtually eliminating the Stretch concept; and allows families to take tax-free 529 plan distributions for student loan repayment.
- A structured settlement is an arrangement in which the injured party (plaintiff) agrees to accept a series of period payments rather than a lump sum settlement. Structured settlements are carried out through the use of a qualified assignment.
- The "life only" settlement options provides for payments that continue throughout the life of the annuitant; upon the annuitant's death, payments cease.
- With the "life only with guaranteed minimum option" settlement the annuitant receives payments that continues for a lifetime. If the annuitant dies before the contract has repaid the initial investment, the balance will be paid in like installments to the contract's beneficiary.
- The surrender charge typically decreases as time passes; but can also be a fixed charge for a specified period of time.
- The withdrawal provision allows a withdrawal up to 10% of the account value after the first year without incurring a surrender fee; some insurers permit withdrawals up to 15%.
- The bailout clause waives surrender charges under certain circumstances such as nursing home confinement, terminal illness diagnoses, death or disability.
- Exceptions to the 10% early withdrawal penalty: disability, death, payment from an immediate annuity, a structured settlement, or substantially equal payments over the taxpayer's life expectancy.

CHAPTER 2 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. _____ annuities are funded with pre-tax money.

   a) Qualified
   b) Nonqualified

2. _____ annuities are funded with after-tax money.

   a) Qualified
   b) Nonqualified

3. An immediate annuity begins making periodic payments to the annuitant, typically within _____ after the policy is issued.

   a) one year
   b) 18 months
   c) two years
   d) 24 months

CHAPTER 3

FIXED OR VARIABLE – WHICH ONE?

As you know, annuities come in two basic forms—Fixed and Variable—but do you really know the differences as well as the similarities?

The **major advantage** to variable policies is that they allow you to participate in various types of investment options while not being taxed on the earnings (until you surrender the policy). You can also apply the interest earned on these investments toward the premiums, potentially lowering the amount you pay.

The **major disadvantage** is that due to investment risks, when the invested funds perform poorly, less money is available to pay the premiums, meaning that you may have to pay more than you can afford to keep the policy in force. Poor fund performance also means that the cash and/or death benefit may decline, though never below a pre-defined level.

VARIABLE VS. FIXED INSURANCE PRODUCTS

With **variable insurance products**, the contract owners, not the insurance companies, assume the investment risk that the value of their benefits will decrease rather than increase under management of their money through the insurance companies. The federal securities laws apply to protect owners in light of this investment risk.

Purchase payments and earnings under these products are invested, usually through separate accounts in funds of stocks, bonds or money market instruments. Benefits vary up and down in dollar value with the increases and decreases in the investment performance of these stocks, bonds or money market instruments.

With **fixed insurance products**, the insurance company, and not the contract owner, assumes the investment risk regarding payment of the rate of interest derived by a formula with reference to an index.

THE FIXED ANNUITY

The main difference, of course, is that a fixed annuity does not fluctuate in value. Though the interest rate guarantee depends on the annuity, fixed rate annuities offer a specific and fully guaranteed rate of return for a specified period.

The fixed annuity is a guaranteed interest bearing policy with guaranteed income options. The insurance company credits interest, and the annuity owner does not pay taxes on the earnings until a withdrawal is made or until receiving annuity income. In addition to the underlying guarantees, the fixed annuity contract earns a competitive return that is considered very safe.

The underlying investments are owned by the insurance company as part of its general account. The insurance company guarantees the value of each in-force annuity policy, which is backed by the general assets of the company. Every fixed annuity contract contains an underlying guaranteed minimum credited interest rate. The minimum interest rate during the accumulation period may be different than the minimum interest rate during the payout period. In addition to the guaranteed underlying interest crediting rate, the annuity company usually declares a current interest rate that is higher than the minimum guaranteed rate, and it is normally guaranteed for a period of time, generally one year. At the end of this period the company will declare a new current credited rate.

A fixed annuity has no direct participation in any other investment

Regardless of how an insurance company hedges or assures itself of having funds available to provide the interest credit, it is guaranteed to be paid by the company. The company does not invest financial assets in the instruments making up the index. Premiums paid for fixed annuities are invested with the insurance company's general funds, chiefly in fixed income types of securities, such as bonds, with the ultimate purpose of providing a level annuity income. The investments the carrier makes provide the underlying guarantees as well as other financial instruments (or hedging strategies) that provide the pre-stated portion of the index return that the client will receive.

Though the fixed annuity affords the contract owner a guaranteed rate of return, that rate is dependent upon the length of time the funds will be invested. Common

maturity periods for annuities are one, three, and five years. The longer the commitment is, the higher the guaranteed rate of return for the contracted period.

Fixed annuities offer security because the rate of return is certain and known beforehand. The risk for performance falls on the company issuing the annuity, and the annuity holder does not have to take on the responsibility of investing the money.

In addition, the 'fixed' nature of these annuities also applies to the amount of the benefit to be paid out during the annuitization period.

With a fixed annuity, the contract owner is protected against rising or declining interest rates, stock market gains or losses, and insurance company profits or losses by assuring safety of principal and ascertaining the exact interest the money will earn. This assurance is very appealing to the conservative investor, allowing the knowledge of specific projections.

However, the moderate to aggressive investor can utilize this type of annuity as a stabilizing factor in his overall portfolio. A diversified investor can use the fixed annuity's guarantee along with other investments (i.e., real estate, stocks, bonds, gold, mutual funds) to add security to their overall investment program.

NO INVESTMENT RISK

Once their contract is issued, annuity owners can count on their payments not to change in amount or frequency. They will enjoy the financial security of a guaranteed income with no investment risk. Economic conditions or investment returns may change, but their payment is guaranteed to remain the same.

FIXED ANNUITY INTEREST RATES

In general, companies offer two interest rates on fixed annuities. The **guaranteed rate** is a minimum rate that the company will credit on the funds in the annuity regardless what interest rates are available in the overall marketplace.

Each state department of insurance, through their own jurisdiction, mandates that annuities provide a lifetime guaranteed interest rate; therefore, most insurance companies offer rates of three to five percent (3% - 5%) on this type of annuity. The contract owner can opt for receipt of guaranteed income payouts on a monthly, quarterly, semi-annual or annual basis.

The **current rate** is a rate of interest that the insurance company credits based on their success with their investment program within their general accounts underlying

the company. The current rate is generally revised and changed once a year, but can be adjusted more frequently on some annuities if specified.

Renewal Rates — The interest rate is credited to an annuity in the years following the initial rate. The renewal rate and the new money rate differ in the following respects.

- The investments that the insurer is buying today are known as the **new money rate**. (This term will be explored more deeply later on.)
- The investments the insurer bought when the annuity was originally purchased are known as the **renewal rate**.

The contract owner should carefully investigate the insurer's renewal rate strategy for any differences.

Bonus Rates — Initial rates can be defined as one-year guarantees or multiple year guarantees. Many fixed annuities will guarantee the rate for the first year and then rates will be declared each year thereafter. Other versions will guarantee rates for part of the term. Annuities that offer multiple year guarantees will guarantee the rate for the full term selected. Terms are typically available for two years to ten years. Generally, the longer the term the higher the guaranteed rate will be. Another version will have guaranteed rates that increase each year for a period of five years or seven years or ten years. Another version of this annuity is where in just one annuity contract the owner has the freedom to allocate the initial deposit into one term or up to all of the terms available (it includes a 2-year term, 3, 4, 5, 6, 7, 8, 9 and a 10-year term). In essence, an effective laddering strategy using annuities can be employed.

Minimum Guaranteed Rates — Under fixed annuities, state insurance law requires insurance companies to guarantee some minimum rate of interest. This guaranteed minimum rate of interest historically was at least three percent (3%) but, under current state law, the rate can range from one percent to three percent (1% - 3%) as a function of the five-year Constant Maturity Treasury yield. Variable annuities do not have any state mandated minimum interest crediting rate or minimum guaranteed surrender value requirements.

Under fixed annuities the owner has assurance of earning a declared or specified minimum rate of interest, in other words, some rate of interest. Under variable annuities, the owner's rate of return is linked to the earnings realized on a pool of assets, and the owner has no assurance that the pool will experience a high, low or, indeed, any increase in investment performance. In fact, investment performance may result in a decrease of the assets and the benefits to which the owner is entitled or under some circumstances the lapse of the policies.

FIXED ANNUITY CREDITING AND INTEREST

Insurance companies have numerous ways to invest fixed annuity funds and credit interest to their contracts.

It's important to emphasize that every such contract contains a guaranteed minimum rate. This provision has always been the backbone of the annuity product and means that the owner's principal is not at risk. Minimum annuity interest rates reflect, in part, the reserving and nonforfeiture requirements that insurers must meet. In effect, the minimum interest rate provides a guaranteed worst-case scenario relative to a fixed contract's growth.

With some product designs, the minimum rate has little meaning. The certificate annuity ('CD-type annuity'), for example, always guarantees the current interest rate through the end of the surrender charge period. In such a case, the minimum interest rate has little bearing on the contract from the contract holder's perspective. With other product designs, notably indexed annuities, the minimum guaranteed rate may be applied to less than 100 % of the contract's principal for the first few years.

THE NEW MONEY RATE

A new money method of crediting interest is sometimes referred to as pocket or bucket investing. In managing the new money interest rate, the insurer places the annuity premium deposits during any given interest rate cycle into a pocket or bucket. Monies are directed into the same bucket as long as interest rates remain relatively stable. In a period of widely fluctuating interest rates, an insurer may open and close a bucket in as short a period as one week. Once these buckets have been established, the insurer evaluates each of them at renewal time to establish the renewal rate. The insurer looks at the cash flows from the underlying investments, reinvestment of the undistributed cash flows and the market value of the investment portfolio, as well as many other factors, before arriving at a renewal rate.

It is important to understand that the declared renewal rate applies only to those contracts issued during the time the bucket was open. This means that each contract holder, in essence, buys into a limited portfolio of investments available at that particular time. This is contrary to the portfolio rate method of investing.

A new money method is the most difficult way to credit and administer annuity interest. A year of heavily fluctuating interest rates results in the creation of numerous buckets. So why do insurers use this method? Most experts agree that it is the fairest way to treat contract holders and the safest way for the insurer to manage their

annuity business. Should interest rates move up or down dramatically, the buckets are in better position to react to those changes because of their structure.

PORTFOLIO RATES

By contrast, portfolio rate interest crediting is simple to understand. All annuity monies go into one large pool or portfolio. The total return of that portfolio is used to establish the interest rate for all contract holders who buy that annuity. When it comes to renewal time, the insurer looks at the entire portfolio, regardless of when each individual investor bought his or her contract, and assigns a renewal rate for the entire block.

Portfolio rate annuities also can use different methods of declaring interest rates. Most portfolio rate insurers simply apply one interest rate to all contract holders within a portfolio. A few insurers with portfolio rate annuities credit interest on a calendar-year basis.

Example:

For example, let's say that Portfolio Life Insurance Company credits interest on a portfolio basis. Each year on January 15 the company sets the rate for the annuity block based on the entire portfolio. Regardless of when a contract holder deposits money with Portfolio Life, he or she earns the interest rate declared until the following January 15th. Most insurers have turned away from this method because of the obvious exposure to volatile interest rate movements.

Theoretically, portfolio rates are considered to be fair to contract holders because rates move up or down with equal probability, and old and new contract holders alike share in these changes. This theory is flawed, however. For example, in a falling rate environment, an insurer credits six percent (6%) to its contracts while comparable carriers credit five percent (5%). This insurer then would either have all the business it wants or be able to achieve tremendous profits. The reverse is supposed to happen in the rising rate scenario, but it does not. This carrier now is forced to acquire new business at six percent (6%) when its competitors offer seven percent (7%). Actually, the first dollar of new business must be acquired at five percent (5%), with competitors at seven percent (7%). This does not happen. To remain competitive, this carrier must close this portfolio and start anew. This means that old deposits never get the advantage of rising rates, but always get the disadvantage of falling rates.

THE BANDING METHOD

Utilizing a year-by-year method of crediting accounts is called the banding approach, which bands the participant's contributions for that particular year. This method is best used when interest rates are rising.

TWO-TIERED INTEREST

Should the participant make a partial or total liquidation of the account, the two-tier approach credits the contract with a lower rate of interest. However, there is a substantial charge for withdrawals and this charge may never disappear. Accounts are credited at an artificially low rate if a minimum payout or period is selected. In many states, this method has been considered unfair and, therefore, those states have banned its use.

FIXED ANNUITY GUARANTEES

Once the annuity contract is issued, the annuitant can count on payments not to change in amount or frequency. They will enjoy the financial security of a guaranteed income with no investment risk. Economic conditions or investment returns may change, but the annuity payment is guaranteed to remain the same.

The guarantees of fixed annuities are the primary appeal to an older population, a dynamic that has been universally recognized across the financial services industry. Given their ability to safeguard and insure principal and previously credited returns, insurance companies are again in a unique position to meet the needs of seniors who are concerned about having their principal exposed to market risk. It is the convergence of this age group's need and the unique ability of insurance carriers that has created the substantial interest in fixed annuity products among seniors.

THE RISKS IN A FIXED ANNUITY

Though a fixed annuity can remove market risk from investment returns, there are also some risks associated with fixed annuities.

The risk of decreasing buyer power — Spending power may decline over the life of the annuity contract as fixed annuities typically do not receive the benefit of cost of living adjustments. Over time, inflation can erode the buying power of the annuity. Inflation protection can be added with some annuities, but that protection is significantly more expensive. If an investor is "locked in" to a fixed interest rate and

the economy is experiencing a period of rising rates, the annuity value can be seriously affected.

The risk of insurer insolvency — If the insurance company that issues the contract fails, the federal government does not provide any protection from financial loss. State guaranty associations provide a certain level of protection; however, that protection has limits.

The risk of death and survivorship — In the case of a single lump sum annuity payment, if the annuitant dies before paying out a full amount equal to that lump sum, the rest of the funds may belong to the insurance company. In a standard single life annuity contract, the survivor (typically the spouse) receives nothing. A joint life annuity can ease this risk.

The risk of dropping interest rates — Since interest rates are notorious for fluctuating, a low interest rate cap may hurt in the long run.

UTILIZING THE FIXED ANNUITY

Now let's meet Sharon, a 65-year old single, hardworking, conservative woman who has never had enough funds to invest.

Example:

Sharon wants to retire and needs to ensure she has the extra income she will need beyond her Social Security retirement benefits, which would be her only income. She recently inherited $250,000 when her parents died. Her home is paid for and her primary goal is to make sure her retirement is comfortable, so she opted to purchase a 20-year fixed annuity with the inherited funds. At a conservative growth rate of 5%, she would receive $1,649.89 per month over the 20-year period. In conjunction with no mortgage payments, the added income will provide her with the extra funds she needs to live more comfortably. At the end of the annuity payout period, Sarah will still have her home equity to rely on if needed.

YEAR	OPENING BALANCE	INTEREST	PAYMENTS	CLOSING BALANCE
1	$250,000.00	$12,330.30	$19,798.68	$242,531.71
2	$242,531.71	$11,948.30	$19,798.68	$234,681.34
3	$234,681.34	$11,546.66	$19,798.68	$226,429.32
4	$226,429.32	$11,124.47	$19,798.68	$217,755.11
5	$217,755.11	$10,680.68	$19,798.68	$208,637.11
6	$208,637.11	$10,214.19	$19,798.68	$199,052.62
7	$199,052.62	$9,723.83	$19,798.68	$188,977.77
8	$188,977.77	$9,208.38	$19,798.68	$178,387.47
9	$178,387.47	$8,666.56	$19,798.68	$167,255.35
10	$167,255.35	$8,097.02	$19,798.68	$155,553.69
11	$155,553.69	$7,498.34	$19,798.68	$143,253.36
12	$143,253.36	$6,869.03	$19,798.68	$130,323.71
13	$130,323.71	$6,207.53	$19,798.68	$116,732.56
14	$116,732.56	$5,512.18	$19,798.68	$102,446.05
15	$102,446.05	$4,781.25	$19,798.68	$87,428.63
16	$87,428.63	$4,012.93	$19,798.68	$71,642.88
17	$71,642.88	$3,205.30	$19,798.68	$55,049.51
18	$55,049.51	$2,356.36	$19,798.68	$37,607.18
19	$37,607.18	$1,463.97	$19,798.68	$19,272.48
20	$19,272.48	$525.94	$19,798.68	$0.00
Totals	**$0.00**	**$145,973.33**	**$395,973.33**	**$0.00**

Table 3.1

THE VARIABLE ANNUITY

The **variable annuity** is a unique investment product that provides tax-deferral of interest and capital gains and the option of a guaranteed monthly income that one cannot outlive. Variable annuities provide the advantages of traditional fixed annuities with the potential returns that are available by investing one's money in the stock market. The investment options that people may choose from in a variable annuity are referred to as **subaccounts**. These subaccounts are structured as either mutual funds or as segregated investment portfolios that are managed by professional investment managers.

A variable annuity offers a range of investment options. The value of the contract will vary depending on the performance of the investment options chosen. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

A variable annuity fluctuates in value according to the performance of its investments, which are held by the company in a separate account outside their general accounts. All variable annuities must be registered with the Securities and Exchange Commission (SEC).

Each variable annuity is unique. Most include features that make them different from other insurance products and investment options. Consumer must keep in mind that they will pay extra for the features offered by variable annuities.

Premiums paid for variable annuities go into separate accounts, where the company is permitted more investment freedom than with its general funds. Separate accounts are generally invested in common stocks and other securities expected to increase in value as prices increase. The ultimate purpose is to provide an annuity income that will maintain its purchasing power in inflationary times.

Variable annuities have insurance features — For instance, if you die before the insurance company starts making income payments to you, many contracts guarantee that your beneficiary will receive at least a specified amount. This is typically at least the amount of purchase payments made. It may also offer additional insurance features such as promising a certain account value or the ability to make withdrawals up to a certain amount each year for the rest of your life.

Variable annuities are tax-deferred — That means you pay no federal taxes on the income and investment gains from your annuity until you make a withdrawal, receive income payments, or a death benefit is paid. You may also transfer your money from one investment option to another within a variable annuity without paying federal tax

at the time of the transfer. When you withdraw your money, however, you will pay tax on the gains at ordinary federal income tax rates rather than lower capital gains rates. Under certain circumstances, the death benefit may not be subject to federal estate tax. In general, the benefits of tax deferral may outweigh the costs of a variable annuity only if you hold it as a long-term investment.

Variable annuities provide periodic income payments — Variable annuities let you receive periodic income payments for a specified period or the rest of your life (or the life of your spouse). This process of turning your investment into a stream of periodic income payments is known as annuitization. This feature offers protection against the possibility that you will outlive your assets.

Tax on withdrawals — Once annuity withdrawals commence, earnings (not principal) will be taxed at the ordinary income rate, rather than at the lower capital gains rates applied to investments in stocks, bonds, mutual funds or other non-tax deferred vehicles in which funds are held for more than one year. Proceeds of most variable annuities do not receive a step-up in cost basis when the owner dies. Other types of investments, such as stocks, bonds, and mutual funds, do provide a step up in tax basis upon the owner’s death.

Guarantees — Insurance companies issuing variable annuities provide a number of specific guarantees; however, these guarantees are only as good as the insurance company that gives them. While it is an uncommon occurrence that the insurance companies that back these guarantees are unable to meet their obligations, it happens. Credit rating agencies should be accessed to determine a company’s financial strength.

Variable rate of return — A variable annuity's rate of return is determined much differently than that of a fixed annuity. The difference is similar to that of a mutual fund vs. a money market account. There is no guaranteed rate for a variable annuity; however there is also the opportunity for higher upside growth. Annuity funds are invested in equities composed of separate subaccounts with various investment options. The annuity contract owner has control over which investments are used, and how money should be allocated across each investment option.

Variable annuities do offer the potential of unlimited upside return as a positive; however the negative is they do not protect against downside losses. It is impossible to predict the rate of return, both positive and negative, because funds are vested in market-linked equities and bonds. The annuity could see a positive yield of 10% one year, while the next year has a 10% negative return. Variable annuities are less predictable than fixed annuities but can yield better returns. In the end, the trade off is the safety of a fixed annuity for the upside potential of a variable annuity.

Insurance producers are required to explain the important facts, including liquidity issues, fees, and market risk.

VARIABLE ANNUITY "FAMILY OF FUNDS"

Many variable annuities offer more than one family of funds to choose from, and within each family of funds they may choose from a variety of funds with different investment objectives. This allows them to diversify their investment portfolio to minimize risk and maximize potential investment return. Unlike fixed annuities, which feature guaranteed protection against loss of principal, the variable annuity's principal is at risk and subject to loss in value.

Variable annuity owners have the option to place funds into subaccounts that vest in different asset classes. Subaccount options vary from plan to plan, but can include money markets, government bonds, corporate bonds, U.S. stocks, and international stocks.

A strong variable annuity will offer a wide range of asset classes in which to invest. Diversification and asset allocation are the two main benefits from multiple investment options. While those benefits may seem similar, they serve two different functions. Diversification is when funds are spread across multiple investments within the same asset class, such as a variety of U.S. stocks. This will mitigate against volatility resulting for individual stock performance. Asset allocation is when funds are spread across multiple assets classes like bonds and stocks. This will lessen exposure from having only one type of investment.

ADVANTAGES OF VARIABLE ANNUITIES

The major advantage of a variable annuity is the tax advantage of deferred taxation on dividends, interest, and capital gains that are credited to the subaccounts in which they are earned—all of which are not taxed until withdrawal. One must be aware that withdrawals prior to age 59½ are subject to a 10% penalty imposed by the IRS and the amount withdrawn is subject to ordinary income tax.

With a variable annuity, one's money is invested in mutual funds, which allow for the opportunity of growth available in the stock market. Variable annuities enable the investor to move money from one subaccount to another without incurring any taxes on the transaction. An aggressive portfolio could be toned down, and a conservative portfolio could be invested more aggressively, all without tax consequences at the time the funds were switched.

These tax benefits of variable annuities attracted a lot of investment dollars, but they still shared all of the downside market risks of mutual funds.

Unlimited Contributions — A drawback of government sponsored retirement plans such as a 401(k) or IRA is there is a limit on the amount that can be contributed annually. There is no limit to the amount of money that can be placed inside a variable annuity, providing the flexibility of unlimited investment. For this reason, they are popular with wealthy investors who are looking for tax shelters.

Tax Deferred Growth — Like all other forms of annuities, variable annuities grow from year to year on a tax-deferred basis. This means that any income or gains accumulated are not taxed until withdrawn. As a result, the money that would have been taxed is still working, increasing the annuity's overall yield. Other investment options, such as mutual funds or certificates of deposit, are taxed annually, meaning a loss of future gains the taxed funds would have added to the overall account value. The distributions are taxable in the year that they are made.

Flexible Premiums — An additional feature common to most variable annuities are flexible premiums. The advantage is in being able to invest a smaller premium upfront and continue adding to the account in the future. With flexible premiums, the contract owner can keep funding the retirement plan, varying periodic contributions according to a changing financial position.

Insurance Protection — Most variable contracts offer an array of living and death benefit riders that promise a guaranteed stream of income or a minimum account value. The living benefit riders pay out a guaranteed stream of income that is based upon a hypothetical guaranteed rate of growth from the subaccounts. The contract owner will still receive this payout even if the subaccounts fall short of this rate of growth. The typical death benefit rider promises the beneficiary the largest of three factors: the current contract value, its highest value on the date of the contract anniversary, or a value based on a guaranteed hypothetical rate of growth.

Potential for Higher Returns — People who put their money in stock subaccounts and leave it there for 20 years or more will probably see a higher return on their investment than can be had from any other type of annuity. Most variable contracts also offer basic money management services, such as periodic rebalancing. The fixed accounts that are available in many variable contracts are often higher than the rates offered by comparable fixed products.

Rebalancing is the process of realigning the weightings of a portfolio of assets. Rebalancing involves periodically buying or selling assets in a portfolio to maintain an original or desired level of asset allocation or risk.

Avoidance of Probate — As with fixed and indexed annuities, variable annuity contracts are unconditionally exempt from probate. That allows the beneficiaries to get their money quickly.

Protection from Creditors — Although this benefit varies somewhat by state, many states mandate that money placed inside variable or other types of annuity contracts cannot be attached by creditors.

Initial Bonuses and High Guaranteed Rates — Many variable annuity contracts will pay an instant bonus on money that is paid into the contract, or they may offer a dollar cost averaging program that pays a high fixed rate on the initial balance and then moves the money into the subaccounts of the contract owner's choice over a set period of time, such as six or twelve months.

Dollar cost averaging (DCA), aka "constant dollar plan," is an investment strategy in which an investor divides up the total amount to be invested across periodic purchases of a target asset in an effort to reduce the impact of volatility on the overall purchase. The purchases occur regardless of the asset's price and at regular intervals; in effect, this strategy removes much of the detailed work of attempting to time the market in order to make purchases of equities at the best prices.

- Dollar cost averaging refers to the practice of dividing an equity investment up into multiple smaller investments of equal amounts, spaced out over regular intervals.
- The goal of dollar cost averaging is to reduce the overall impact of volatility on the price of the target asset; as the price will likely vary each time one of the periodic investments is made, the investment is not as highly subject to volatility.
- Dollar cost averaging aims to avoid making the mistake of making one lump sum investment that is poorly timed with regard to asset pricing.

VARIABLE ANNUITY CONTRACT RISKS

All types of investments, at varying degrees, carry inherent risks. The variable annuity is not an appropriate choice for the investor who has short-term goals—the variable annuity investor must have long-term goals in sight. Variable annuities come with high annual fees and, when added up, these fees can diminish any investment gains.

Early withdrawals carry penalties—higher fees, substantial tax assessments—the investor who does not have extra funds set aside for emergencies can be put in a

bad position if unprepared. Because of the volatile nature of market investments, if the underlying investments perform badly, so does the annuity. During prosperous times, variable annuities can reward investors who are willing to take on higher risk by providing more aggressive returns; however, during not-so-good times, such as a recession, variable annuities pose much more risk than fixed annuities.

Despite their versatility, variable annuities are not all things to all people and do have some real limitations.

Poor cost basis — Unlike stocks or other securities, the cost basis of variable annuities does not step up when they are inherited. Beneficiaries will pay tax on the entire contract value that has grown from the date of the initial purchase.

Poor tax treatment — Although variable contracts grow tax-deferred until retirement, they impose the same10% early withdrawal penalty as traditional IRAs and qualified plans. All distributions from these contracts are taxed as ordinary income unless the contract was placed inside a Roth IRA. A similar long-term investment in index funds that do not pay dividends could yield similar growth, but with total liquidity and lower taxes on long-term gains.

High fees — Variable annuities are one of the most expensive financial products in the marketplace. They come with myriad fees and charges, including mortality and expense fees, mutual fund subaccount management fees, contract maintenance fees, and other miscellaneous costs. Some contracts will charge transaction fees after a certain number of transactions have been made within the contract. Living and death benefit riders also subtract periodic fees from the contract balance. Most contracts also come with substantial back-end surrender charge schedule that may not expire for 10 years or longer.

Complexity — Variable annuities are one of the most complicated financial instruments available today, and they are often poorly marketed and understood by both salespersons and consumers.

Not a short-term savings vehicle — Variable annuities are not a short-term investment vehicle. Surrender charges, which would reduce the value of your contract, may apply. The benefits of tax deferral and living benefit protections also mean the contract is most beneficial to those with a long time horizon.

Contract fees and expenses — Contract fees and expenses may be significant. These may include deductions from purchase payments, surrender charges, and significant ongoing fees and expenses associated with owning a contract.

Risk of loss — You can lose money in a variable annuity, including potential loss of your original investment.

Risks associated with investment options:

- The value of your investment and any returns will depend on the performance of the investment options you choose.
- Each underlying fund may have its own unique risks. You should review the investment option's prospectus before making an investment decision. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio.

Optional Features — Optional features may carry investment restrictions. Or, the benefits of the optional features may be significantly reduced if withdrawals over a certain amount are made or if withdrawals are taken before you reach a certain age.

Insurance company risk — The financial strength of the insurance company that issues the contract backs all guarantees, including the death benefit, living benefits, and annuity payments. If the insurance company experiences financial distress, it may not be able to meet its obligations.

VARIABLE ANNUITY ACCUMULATION PERIOD

During a variable annuity's accumulation period, all premium payments can be invested in either a fixed account or subaccounts, or both. The fixed account earns a guaranteed rate of interest, and the principal is also guaranteed and not subject to market fluctuations. Premiums invested in the subaccounts (mutual funds) have the opportunity to participate in the growth of the stock market, but these funds are subject to market risk.

It can be demonstrated historically that funds invested in a diversified portfolio of prudently invested stocks can outperform other investment options, given enough time.

VARIABLE ANNUITY FEES AND EXPENSES

Consumers will pay several fees and expenses when investing in a variable annuity. Consumer must understand all the fees and expenses before they invest. These fees

and expenses will reduce the value of the variable annuity account and the return on investment.

Surrender charge – If money is withdrawn from a variable annuity within a certain period of time after a purchase payment, the insurance company will usually assess a surrender charge. Generally, the surrender charge is a percentage of the amount withdrawn or purchase payments made.

The surrender charge often declines gradually over a period of several years, known as the **surrender period**. For example, a seven percent (7%) charge might apply in the first year after a purchase payment, six percent (6%) in the second year, five percent (5%) in the third year, and so on. Typically, after six to eight years or sometimes as long as ten years, the surrender charge may no longer apply. Often, contracts will allow partial withdrawals of the account value each year without paying a surrender charge.

Example:

Susan purchased a variable annuity contract with a $100,000 purchase payment. The contract has a schedule of surrender charges, beginning with a seven percent (7%) charge in the first year, and declining by one percent (1%) each year. In addition, she can withdraw 10% of the contract value each year free of surrender charges. In the first year, she decides to withdraw $50,000. This is one-half of the contract value of $100,000 (assuming tat the contract value has not increased or decreased because of investment performance). In this case, she can withdraw $10,000 (10% of contract value) free of surrender charges. She will pay a surrender charge of seven percent (7%), or $2,800, on the other $40,000 withdrawn.

Base contract fee – This fee (often referred to as “Mortality and Expense [M&E] Risk Charge”) is equal to a certain percentage of the account value, typically in the range of 1.25 percent (1.25%) per year. This fee compensates the insurance company for insurance risks it assumes under the annuity contract. A portion of this fee is sometimes used to pay commissions to the financial professional for selling the variable annuity.

Example:

Susan’s variable annuity has a mortality and expense charge at an annual rate of 1.25 percent (1.25%) of account value. The average account value during the year is $100,000, so Susan will pay $1,400 in mortality and expense charges that year.

Administration fees – The insurer may also deduct fees to cover recordkeeping and other administrative expenses. This may be charged as a flat account maintenance

fee (i.e., perhaps $25 or $50 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

Example:

Susan's variable annuity charges administrative fees at an annual rate of 0.15% of account value. The average account value during the year is $100,000. Susan will pay $150 in administrative fees.

Underlying fund expenses – The policyowner will also indirectly pay the fees and expenses for the mutual funds that were chosen as the investment options. These fees are in addition to the fees charged by the insurance company and are deducted from the returns of the investment options.

Fees and expenses for optional features – Special features offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and expenses.

Other fees may also apply – These may include initial sales loads/charges or fees for transferring part of the account from one investment option to another.

The financial professional should explain all fees and expenses that may apply. A description of the fees and expenses will be contained in the prospectus for any variable annuity that the consumer is considering.

A variable annuity may offer different share "classes" with different fees and expenses (including differing mortality and expense charges) and different surrender charge periods. For example, "L class" shares may have a shorter surrender charge period, but may have higher ongoing fees, while "B class" shares may have a longer surrender charge period and lower ongoing fees. The consumer should consider how long they expect to own the variable annuity along with their need to access funds when they think of any tradeoff between the length of the surrender charge period and the level of ongoing fees.

Contract fees may go toward the financial professional's compensation. That means they may receive higher compensation for selling some contracts (and for different share classes of the same contract) than others.

EXCHANGING ONE VARIABLE ANNUITY FOR ANOTHER

In some cases, the policyowner may wish to exchange an existing variable annuity contract for a new annuity contract that has features they prefer. If they exchange

contracts, they may be required to pay surrender charges on the old annuity if they are still in the surrender charge period. In addition, a new surrender charge period may begin when the exchange into the new annuity takes place.

The new variable annuity may have a lower contract value and a smaller death benefit. An annuity should only be exchanged when it is better for the investor, not just better for the person trying to sell a ne w annuity.

BONUS CREDITS

Many variable annuities offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from one percent to five percent (1% to 5%) for each premium payment made.

Example:

Susan purchased a variable annuity contract that offers a bonus credit of three percent (3%) on each purchase payment. She makes a purchase payment of $20,000. The insurance company issuing the contract adds a bonus of $600 to her account.

Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. The consumer should ask themselves if the bonus is worth more to them than any increased charges they will pay for that bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long they hold onto the annuity contract, and the return on the underlying investments.

Frequently, insurers will charge for bonus credits in one or more of the following ways:

- **Higher surrender charges** – Surrender charges may be higher for a variable annuity that pays a bonus credit than for a similar contract with no bonus credit.
- **Longer surrender periods** – Purchase payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit.
- **Higher mortality and expense risk charges and other charges** – Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays a bonus credit. Although the difference may seem small,

overtime it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.

Example:

Susan makes purchase payments of $100,000 in Annuity A and $100,000 in Annuity B. Annuity A offers a bonus credit of four percent (4%) on the purchase payment, and deducts annual fees and expenses totaling 1.75 percent (1.75%). Annuity B has no bonus credit and deducts annual fees and expenses totaling 1.25 percent (1.25%). Let's assume that both annuities have an annual rate of return, prior to expenses, of10%. By the tenth year, the account value in Annuity A will have grown to $229,780. But the account value in Annuity B will have grown more, to $231,360, because Annuity B deducts lower annual fees and expenses, even though it does not offer a bonus.

Bonuses may only apply to the initial purchase payment, or to purchase payments made within the first year of the annuity contract. Consumers should take a hard look at variable annuities offering bonus credits. In some cases, the "bonus" may not be in the consumer's best interest. Variable annuities with bonus credits may impose higher fees and expenses than variable annuities that do not offer bonus credits. Higher expenses can outweigh the benefit of the bonus credit offered. In certain circumstances (such as death, annuitization, or surrendering the contract within a few years of purchasing it), the bonus credits are required to be paid back to the insurance company.[6]

VARIABLE ANNUITY DEATH BENEFIT AND OTHER OPTIONAL INSURANCE FEATURES

Variable annuities have a death benefit. If the annuitant dies before the insurer has started making payments, the beneficiary is guaranteed to receive a specified amount, typically at least the amount of the purchase payment. The beneficiary is entitled to this benefit, even if at the time of the annuitant's death the account value is less than the guaranteed amount. Usually, in case of an annuity holder's death, the beneficiary will receive the greater of two values:

- All the money in the account; or
- Some guaranteed minimum (for example, all purchase payments minus prior withdrawals).

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[6] Investor.gov, Updated Investor Bulletin: Variable Annuities, Oct. 2018, https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-5

Example:

Susan owns a variable annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. She made purchase payments totaling $100,000. In addition, she has withdrawn $20,000 from the account. Because of these withdrawals and investment losses, the account value is currently $75,000. If she dies, the designated beneficiary will receive $80,000 (the $100,000 in purchase payments minus $20,000 in withdrawals).

Some variable annuities offer a **stepped-up death benefit** that provides an additional return on the payments if the variable annuity is held for a long period of time. Under this feature, the guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. The guaranteed minimum specified in the annuity may be the account value as of a specified date. The purpose of a stepped-up death benefit is to "lock in" the investment performance and prevent a later decline in the value of the account from eroding the amount an annuity holder expects to leave to his or her heirs. However, this feature carries a charge, which reduces the account value as well as some other advantages and disadvantages.

- **Stepped-Up Death Benefit** — In event of death during the accumulation period of a variable annuity, many companies have this provision. The death benefit paid to the beneficiary is the greater of:
    - The contract value at the time of death;
    - The total premiums paid into the contract; or
    - The contract value on the prior (i.e., 5th, 6th, 7th) anniversary date of the contract.

An **earnings enhancement death benefit** pays an additional amount that is usually equal to a percentage (e.g., 25% or 40%) of the contract's earnings at death. The purchase of this death benefit is to help offset any taxes due upon death.

Variable annuities commonly offer other optional insurance features, which also have extra fees. Many of these optional features are available during the accumulation phase of the contract. Collectively, these features may be referred to as "living benefits."

Guaranteed lifetime withdrawal benefits, which provide that the policyowner can withdraw up to a certain amount each year for as long as they live regardless of market performance;

- *e.g.,* the policyowner can withdraw up to six percent (6%) of their purchase payments each year for as long as they live even if the contract value is reduced to zero.

Guaranteed minimum income benefits, which provide a minimum value the policyowner can turn into a stream of income payments regardless of market performance;

- *e.g.,* at a minimum the policyowner will be ale to annuitize the value of the initial purchase payments accruing interest at five percent (5%) per year.

Guaranteed minimum accumulation benefits, which provide that the contract value will be at least equal to a stated minimum amount after a specified number of years regardless of market performance;

- *e.g.,* at the end of year ten, the contract value will be at least 120% of the first year's purchase payments.

Other features may include long-term care insurance, which pays for home health care or nursing home care if the policyowner becomes seriously ill.

***Note**: Living Benefits will be discussed in detail as we progress through the course material.*

The processing time for death claims once the death certificate has been received is about two weeks. Most insurance companies do not charge a fee for liquidation of an account due to death; most companies pay out the total value of the account.

VARIABLE ANNUITY REQUIRED MINIMUM DISTRIBUTIONS

To be taxed as an annuity under Section 72(s) of the IRS Code, all nonqualified annuity contracts must contain the following two provisions.

- If the owner of the annuity begins withdrawing money from the annuity and dies, the policy must allow withdrawals to continue at the same rate or faster.
- If the owner of the annuity dies before withdrawals have begun, and the beneficiary of the annuity is the spouse of the owner, the annuity may be continued with the spouse as the new owner.

If the owner dies before withdrawals have begun and the beneficiary is not the spouse of the owner, then: (1) the entire value of the contract must be distributed within five years of the owner's death or (2) beginning within one year of the date of

the death of the owner, the beneficiary may elect to begin distribution of the proceeds over his/her life expectancy.

VARIABLE ANNUITY WITHDRAWALS AND RETURNS

Withdrawals may be made from the contract at any time prior to retirement as well, usually with a minimum dollar amount and at the option of the owner.

Withdrawals, including systematic withdrawals (see below), from a nonqualified variable annuity are first treated as taxable income if the value of the annuity is greater than the investment in the annuity at the time the withdrawal is made.

In the case of a full withdrawal from an annuity contract, taxes are paid only on the gain above the "investment in the annuity."

When an annuity is annuitized with a life expectancy (may also have period certain, etc.), it is uncertain how long the annuitant will live. The IRS mortality table (found in the appendix of IRS Publication 590) is used to determine what the expected return is.

Systematic withdrawal plan — A systematic withdrawal plan enables the owner to pre-authorize periodic withdrawals. The contract owner instructs the company to withdraw either a percentage or a level dollar amount from the contract on a monthly, quarterly, semi-annual, or annual basis. Checks are sent directly to the owner or can be deposited directly into the owner's bank account.

Distribution period — During retirement, funds can be withdrawn from the contract, and the owner has several options from which to choose.

VARIABLE ANNUITY ANNUITIZATION

Annuitization is one of the least utilized, and one of the most misunderstood options, of a variable annuity contract. The contract owner may elect to allocate all or part of the value of the contract to either the fixed account and/or the separate account. Allocations to the fixed account will provide annuity payments on a fixed basis. Amounts allocated to the separate account will provide annuity payments on a variable basis, reflecting the investment performance of the underlying subaccount.

TRANSFERS BETWEEN SUBACCOUNTS

In addition to the variable annuity's investment options (subaccounts), many offer a fixed account or fixed investment option. During the accumulation phase of the

deferred variable annuity, the owner can allocate payments to one or more variable options as well as to a fixed interest option.

The contract owner may transfer all or part of the value of the contract to the fixed account, sometimes called the guaranteed account, and may elect to annuitize those funds. In essence, the contract owner purchases, for a fixed dollar amount, a monthly income that will be paid to him/her until death.

The contract owner may also transfer all or part of the value of the contract to one or more of the subaccounts that are available in the separate account and may elect to annuitize those funds.

Example:

For example, if there were 12 subaccounts available in the separate account, the owner could transfer $25,000 into the growth and income subaccount and $30,000 into the international subaccount, and annuitize each account.

The difference between annuitizing funds in the fixed account and annuitizing funds in the separate account is that funds in the fixed account produce a guaranteed income that will not change from period to period. Funds that are annuitized in the separate account produce an income that will change from period to period based on the performance of the subaccount in which the funds are placed.

Within limits, variable annuity subaccounts may be reallocated by the consumer when desired. There will often be a limit on how many transactions in which one person can engage during a month or a quarter without incurring additional fees. Many variable annuities will allow the investor to pick an allocation model and have their subaccounts automatically rebalanced based on the chosen allocation model.

Assuming there is a guaranteed minimum death benefit rider in effect on the annuity, should an investor die during the accumulation phase of a variable annuity, the beneficiary will receive the greater of two amounts: The entire amount of the annuity premiums less withdrawals, or the current value of the investment.

VARIABLE ANNUITY TAX RULES

The federal tax rules that apply to variable annuities can be complicated. In addition, there may be state tax implications. Before investing, consumers may want to consult a tax adviser about the tax consequences of investing in a variable annuity.

Retirement plans, like IRAs and employer-sponsored 401(k) plans, may also provide tax-deferred growth and other tax advantages. For many investors, it will be best to

max out their contributions to IRAs and 401(k) plans before investing in a variable annuity.

If investing in a variable annuity through a tax-advantaged retirement plan, the investor will get no additional tax advantage from the variable annuity.

There may be federal tax penalties if funds are withdrawn before a certain age.

FILLING THE CONSUMER'S NEED WITH A VARIABLE ANNUITY

Of course, as you know, a variable annuity fluctuates in value according to the performance of its underlying investments (separate or subaccounts), which are held by the company in a separate account outside their general accounts.

Premiums paid for variable annuities are directed by the annuity owner into these separate accounts where the company is permitted more investment freedom than with its general funds. Separate accounts are generally invested in common stocks and other securities that are expected to increase in value as prices increase. The purpose of a variable annuity is to provide an annuity income, which will maintain its purchasing power in inflationary times.

Unless the owner of a variable annuity purchases additional riders (living benefits), they have no guarantee of safety of principal and bear all of the investment risk associated with their separate account choices.

Variable annuities are typically appropriate for those individuals with longer time horizons or those who are able to handle market fluctuations.

The variety of features offered by variable annuity products can be confusing. For this reason, it can be difficult for investors to understand what's being recommended for them to buy.

Any investor who believes they were wrongly sold a variable annuity can file a complaint online at FINRA's Investor Complaint Center. Following is a listing of concerns FINRA has published in their Investor Alerts program for individuals who are considering purchasing a variable annuity.[7]

Liquidity and early withdrawals — Deferred variable annuities are long-term investments. Getting out early can mean taking a loss.

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[7] finra.org/nvestors/alerts/variable-annuities, *Beyond the Hard Sell,* Aug. 31, 2009

Sales and surrender charges — Most variable annuities have a sales charge. Like class B shares of mutual funds, many variable annuity shares typically do not charge a front-end sales charge, but they do impose asset-based sales charges or surrender charges. These charges normally decline and eventually are eliminated the longer the shares are held.

Fees and expenses add up — Annual fees on variable annuities can reach two percent (2%) or more of the annuity's value; so the consumer must be made aware that they will pay for each variable annuity benefit. If they don't need or want these features, they should consider whether this is an appropriate investment for them.

UTILIZING THE VARIABLE ANNUITY

Now let's meet Donald, a 65-year old who has a $1 million mutual fund portfolio. He desires an annual income of $60,000 per year. In mutual funds alone, his portfolio is vulnerable to market risk and he could run out of money too soon.

A possible solution is to convert a portion of the mutual fund portfolio to a variable annuity with a five percent (5%) income rider to create a guaranteed income stream to help protect him from market fluctuations.

By shifting $300,000 out of the mutual fund portfolio into an annuity with a living benefit rider:

- Mutual fund portfolio withdrawal rate is reduced to 3.57%;
- Amount of guaranteed income increased 25%.

With the annuity, less than half of the client's income is subject to market fluctuations. The confidence factor is increased by 11 percentage points.

VARIABLE ANNUITY BUYOUT OFFERS

In the years prior to the recent financial crisis, many insurance companies offered variable annuities that included generous benefits. Some such offers promised the benefit of paying contract owners a minimum amount each year, even if the financial markets declined. Others promised minimum death benefits if a contract owner passed away. However, some insurance companies began reconsidering those benefits because of the high cost to maintain them in a lower economic environment.

As a result, if an individual owned a variable annuity, they may have received an offer from the insurance company asking them to accept a buyout offer. A buyout offer refers to an offer by an insurance company to either: (1) increase the contract value

in exchange for giving up a benefit; or (2) increase the cash surrender value in exchange for surrendering the variable annuity.

- **If the contract owner accepts a buyout**, the variable annuity's contract value will increase, but the benefit will be lost. This can be an attractive option if the contract owner is no longer interest in that particular benefit.
- **If the contract owner surrenders the contract**, they will receive an increase to the contract's cash surrender value, and they will no longer own the variable annuity. This can be an attractive option of the contract owner no longer wants to own a variable annuity or if they want to purchase another variable annuity with different features, such as different benefits or investment options.

Consumers should be aware that the amount of the offer (the amount by which the contract value or cash surrender value may increase if the offer is accepted) may fluctuate. Insurance companies may make buyout offers because it is in their own best interest to do so. The insurance company does not make a buyout offer solely based on a determination that it is in the consumer's best interest. A buyout offer should only be accepted when the consumer determines that it is better for them to accept the buyout offer rather than continue to own the variable annuity with a particular benefit. This determination can only be made when the consumer knows all the facts!

Before accepting a variable annuity buyout offer, here a few of the questions that the contract owner should consider asking to help understand the possible effects of their decision.

- ***Has the contract owner's situation or that of the insurance company changed?***

Consider whether the contract owner's personal situation has changed since the time of the original decision to purchase a variable annuity. For example, a decline in health may make promises for long-term payments less important. Likewise, a personal financial emergency could make a large lump sum payment more desirable than a promise to provide long-term payments.

Likewise, a decline in the financial health of the insurance company may cause concern that the insurance company might not be able to make payments in the future. This may make long-term promises from the insurance company less attractive.

If there has been no change in the contract owner's personal situation or that of the insurance company, deciding if accepting the buyout offer is right for the consumer

should be questioned. A lump sum payout or an increase to the value of the contract may be attractive, but consider whether that outweighs the benefits provided by the variable annuity.

- ***Would accepting the buyout offer have any additional financial impact?***

Accepting a buyout offer may cause surrender charges upon surrender of the variable annuity. The amount that may be charged decreases over a period of several years (the surrender period). For example, a seven percent (7%)charge might apply if the contract is surrendered within the first year after purchasing it, a six percent (6%) charge in the second year, five percent (5%) in the third year, and so on until the end of the surrender period when the surrender charge would no longer apply.

Transferring cash surrender value to a different financial product (which may be another variable annuity) may trigger a new sales charge or subject the contract owner to a new surrender charge period. Also, new financial products, including variable annuities, offered in the current economic environment may have higher fees or be less favorable than the benefits offered by the variable annuity currently owned.

Consumers should be cautious if offered a new variable annuity with features similar to those offered by the current variable annuity. While the features may appear similar, they should consider the fees (including surrender charges and benefit fees), investment restrictions, and benefits and risks of the new variable annuity as compared to the current variable annuity.

Surrendering the variable annuity for a lump sum payment or using the surrender proceeds to purchase another financial instrument may also result in tax liability. The contract owner may face the 10% federal income tax penalty if money is withdrawn before age 59½. In addition, if the variable annuity is surrendered and the assets are not transferred to another annuity, the surrender amount may be taxable.

- ***Has the consumer consulted with an investment professional?***

An investment professional may be able to help the contract owner better understand the pros and cons of a buyout offer; however, that professional may receive a commission for selling a new annuity or for persuading the contract owner to accept

the buyout offer. The investment professional is required to disclose any conflicts of interest they may have.[8]

WHAT TO DO BEFORE INVESTING IN A VARIABLE ANNUITY

Know how it works. Look up key terms you might not be familiar with. Be prepared to ask your financial professional questions about whether the contract is right for you.

Figure out how much it costs. Ask what the fees and expenses are. Are there surrender charges, and how long is the surrender period? Is there a bonus credit?

Get the details. Different contracts have different features. Ask your financial professional for the variable annuity prospectus, which will describe the contract you're considering in detail. Read the prospectus carefully and ask questions about what you don't understand.

The prospectus is available free of charge. It contains important information about the variable annuity, including fees and expenses, investment options, death benefits and other insurance features, and annuity payout options.

Consumers must remember:

- Variable annuities could help meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals. Substantial taxes and surrender charges ma apply if money is withdrawn early.
- Variable annuities involve investment risks just like mutual funds do. If the investment choices selected for the variable annuity perform poorly, the account could lose money.
- Contract fees may go toward the financial professional's compensation. That means they may receive higher compensation for selling some contracts or investment products than for others.

QUESTIONS THAT SHOULD BE ASKED AND ANSWERED

- Will the consumer use the variable annuity primarily to save for a long-term goal like retirement?

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[8] SEC Investor.gov, Investor Bulletin: Variable Annuities - Should You Accept a Buyout Offer? https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-21

- Is the consumer investing in the variable annuity outside of a retirement plan or IRA so that he/she can take advantage of the tax-deferral benefit of the variable annuity?
- Is the consumer willing to take the risk that the account value may decrease if the underlying mutual fund investment options perform badly?
- Does the consumer understand the insurance features of the variable annuity? How do the insurance features meet the consumer's needs?
- Does the consumer understand all of the fees and expenses that the variable annuity charges? How much would the consumer pay for different insurance features or different mutual funds?
- Does the consumer intend to remain in the variable annuity long enough to avoid paying any surrender charges if money is withdrawn?
- How doe the variable annuity fit in with the consumer's overall investment portfolio?
- Are there features of the variable annuity, such as long-term care insurance, that the consumer could purchase more cheaply separately?
- Has the consumer consulted with a tax adviser and considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on the consumer's tax status in retirement?
- If the consumer is exchanging one annuity for another one, doe the benefits of the exchange outweigh the costs, such as any surrender charges if money is withdrawn before the end of the surrender charge period for the new annuity?

A Change of Mind

Consumers may cancel their contract within a short period of receiving it without incurring a surrender charge, if they change their mind on the purchase. Upon cancellation, they will receive a refund of any purchase payments made, but the refund may be adjusted up or down to reflect the performance of the investment options. This is the "free look period" and may vary depending on the state in which the annuity was purchased.

Sub-advisor Accounts for Variable Annuities

Sub-advisor accounts pool money from many investors and invest the money in securities such as stocks, bonds, and short-term debt. The combined holdings are

known as its portfolio. Investors buy shares and each share represents an investor's part ownership and the income it generates.

Sub-advisor accounts are a popular choice among investors because they generally offer the following features:

- **Professional Management** — Managers do the research for the consumer. They select the securities and monitor the performance.
- **Diversification or "Don't put all your eggs in one basket"** — Funds are typically invested in a range of companies and industries. This helps to lower the consumer's risk if one company fails.
- **Affordability** — Most funds set a relatively low dollar amount for initial investment and subsequent purchases.
- **Liquidity** — Investors can easily redeem their shares at any time, for the current net asset value (NAV) plus any redemption fees.

Investors usually buy shares through a broker, rather than from other investors. The price that investors pay is net asset value per share plus any fees charged at the time of purchase, such as sales loads.

Shares are "redeemable," meaning investors can sell the shares back at any time. Payment must be sent within seven days.

UNDERSTANDING THE FEES

As with any business, costs are involved. These costs are passed along to investors by charging fees and expenses. Fees and expenses vary. An account with high costs must perform better than a low-cost account to generate the same returns.

Even small differences in fees can mean large differences in returns over time.

Example:

For example, if an individual invested $10,000 with a 10% annual return, and annual operating expenses of one and one-half percent (1.5%), after 20 years they would have roughly $49,725. If they invested the same amount with the same performance and expenses of 0.5 percent (0.5%), after 20 years they would end up with $60,858.

It takes only minutes to use a cost calculator to compute how the costs of different accounts add up over time and can eat into the policy's returns.

Regular and recurring operating expenses are usually paid out of assets, rather than by imposing separate fees and charges on investors. (Keep in mind, however, that because these expenses are paid out of assets, investors are paying them indirectly.)

A frequently asked question is whether the Securities and Exchange Commission imposes any specific limits on the size of the fees that may be charged. The short answer is the Securities and Exchange Commission generally does not, although the SEC limits redemption fees to two percent (2%) in most situations. The Financial Industry Regulatory Authority (FINRA), however, does impose limits on some fees.[9]

The prospectus contains a fee table under the heading of “Shareholder Fees” in which details on the fees are explained.

SALES LOADS

When brokers are used to sell shares, brokers must be compensated. Brokers are compensated by a fee that is imposed on the investor—this is known as the “sales load.”

In this respect, a sales load is like a commission investors pay when they purchase any type of security from a broker. Although sales loads most frequently are used to compensate outside brokers that distribute shares, some that do not use outside brokers still charge sales loads. The Securities and Exchange Commission does not limit the size of sales load that may be charged, but FINRA does not permit sales loads to exceed 8.5%. If other types of charges are imposed, the percentage is lower. Most do not charge the maximum.

There are two general types of sales loads—a front-end sales load investors pay when they purchase shares and a back-end or deferred sales load investors pay when they redeem their shares.

SALES CHARGE (LOAD) ON PURCHASES

The category "Sales Charge (Load) on Purchases" in the prospectus fee table includes sales loads that investors pay when they purchase shares (also known as "front-end sales loads"). The key point to keep in mind about a front-end sales load is it reduces the amount available to purchase shares.

Example:

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[9] SEC, Mutual Fund Fees and Expenses, https://www.sec.gov/fast-answers/answersmffeeshtm.html

For example, if an investor writes a $10,000 check for the purchase of shares, and there is a five percent (5%) front-end sales load, the total amount of the sales load will be $500. The $500 sales load is first deducted from the $10,000 check (and typically paid to a selling broker), and assuming no other front-end fees, the remaining $9,500 is used to purchase shares for the investor.

DEFERRED SALES CHARGE (LOAD)

The category "Deferred Sales Charge (Load)" in the prospectus fee table refers to a sales load that investors pay when they redeem shares (that is, sell their shares back). You may also see this referred to as a "deferred" or "back-end" sales load. When an investor purchases shares that are subject to a back-end sales load rather than a front-end sales load, no sales load is deducted at purchase, and all of the investors' money is immediately used to purchase shares (assuming that no other fees or charges apply at the time of purchase).

Example:

For example, if an investor invests $10,000 with a five percent (5%) back-end sales load, and if there are no other "purchase fees," the entire $10,000 will be used to purchase shares, and the five percent (5%) sales load is not deducted until the investor redeems his or her shares, at which point the fee is deducted from the redemption proceeds.

Typically, the amount of a back-end sales load is calculated based on the lesser of the value of the shareholder's initial investment or the value of the shareholder's investment at redemption. For example, if the shareholder initially invests $10,000, and at redemption the investment has appreciated to $12,000, a back-end sales load calculated in this manner would be based on the value of the initial investment—$10,000—not on the value of the investment at redemption.

The most common type of back-end sales load is the "contingent deferred sales load," also referred to as a "CDSC," or "CDSL." The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.

Example:

For example, a contingent deferred sales load might be five percent (5%) if an investor holds his or her shares for one year, four percent (4%) if the investor holds his or her shares for two years, and so on until the load goes away completely. The rate at which this fee will decline will be disclosed in the prospectus.

A class with a contingent deferred sales load typically will also have an annual 12b-1 fee.[10]

Redemption Fee

A redemption fee is another type of fee that is charged to shareholders when the shareholders redeem their shares. Although a redemption fee is deducted from redemption proceeds just like a deferred sales load, it is not considered to be a sales load. Unlike a sales load, which is used to pay brokers, a redemption fee is typically used to defray costs associated with a shareholder's redemption and is paid directly to the account, not to a broker. The Securities and Exchange Commission limits redemption fees to two percent (2%).

Exchange Fee

An exchange fee is a fee that is imposed on shareholders if they exchange (transfer) to another account within the same group.

Account Fee

An account fee is a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some may impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

Purchase Fee

A purchase fee is another type of fee that is charged to shareholders when the shareholders purchase their shares. A purchase fee differs from, and is not considered to be, a front-end sales load because a purchase fee is paid to the account (not to a broker) and is typically imposed to defray some of the costs associated with the purchase.

Management Fees

Management fees are fees that are paid out of assets to the investment adviser (or its affiliates) for managing the investment portfolio, and administrative fees payable to the investment adviser that are not included in the "Other Expenses" category.

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[10] SEC, Mutual Fund Fees and Expenses, https://www.sec.gov/fast-answers/answersmffeeshtm.html#salesloads

DISTRIBUTION [AND/OR SERVICE] (12b-1) FEES

This category identifies “12b-1 fees,” which are fees paid out of assets to cover distribution expenses and sometimes shareholder service expenses. “12b-1 fees” get their name from the Securities and Exchange Commission rule that authorizes payment. “Distribution fees" include fees paid for marketing and selling shares, such as compensating brokers and others who sell shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. The Securities and Exchange Commission does not limit the size of 12b-1 fees that may be paid. But under FINRA rules, 12b-1 fees that are used to pay marketing and distribution expenses (as opposed to shareholder service expenses) cannot exceed 0.75 percent (0.75%) of the average net assets per year.

Some 12b-1 plans also authorize and include "shareholder service fees," which are fees paid to persons to respond to investor inquiries and provide investors with information about their investments. Shareholder service fees may be paid without adopting a 12b-1 plan. If shareholder service fees are part of a 12b-1 plan, these fees will be included in this category of the fee table. If shareholder service fees are paid outside a 12b-1 plan, then they will be included in the "Other Expenses" category, discussed below. FINRA imposes an annual .25 percent (0.25%) cap on shareholder service fees (regardless of whether these fees are authorized as part of a 12b-1 plan).

OTHER EXPENSES

Included in this category are expenses not included in the categories “Management Fees” or “Distribution [and/or Service] (12b-1) Fees.” Examples include shareholder service expenses that are not included in the “Distribution [and/or Service] (12b-1) Fees” category; custodial expenses; legal expenses; accounting expenses; transfer agent expenses; and other administrative expenses.

TOTAL ANNUAL OPERATING EXPENSES

This line of the fee table is the total of the annual fund operating expenses, expressed as a percentage of the average net assets.

RISKS AND BENEFITS

Money Market Funds — These funds are limited by law to certain high quality, short-term investments issued by U.S. corporations, and federal, state and local governments, and have relatively low risks compared to other funds.

Bonds — These funds are also referred to as **fixed income funds**. They have higher risks than money market funds, because they seek to pay higher yields. Unlike money market funds, bond funds are not restricted to high quality or short-term investments. Because there are many different types of bonds, the risks and rewards of bond funds can vary dramatically.

Stocks — These funds are also referred to as **equity funds** and generally involve more risk than money market or bond funds, but they can also offer the highest returns. A stock fund's value can rise and fall quickly over the short term, but historically stocks have performed better over the long term than other types of investments. Not all stock funds are the same:

- Growth funds focus on stocks that may not pay a regular dividend by have potential for above average financial gains;
- Income funds invest in stocks that pay regular dividends;
- Index funds track a particular market index such as the Standard & Poor's 500 index;
- Sector funds specialize in a particular industry segment.

Target Date — These accounts hold a mix of stocks, bonds, and other investments. Over time, the mix gradually shifts according to the account's strategy. Target date funds, sometimes known as lifecycle funds, are designed for individuals with particular retirement dates in mind.

The higher the potential return, the higher the risk of loss

Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways.

First, variable annuities let you receive periodic payments for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.

Second, variable annuities have a death benefit. If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount—typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.

Third, variable annuities are tax-deferred. That means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals.

Advantages	Disadvantages
• Managed by professional money managers • Investment risk is spread out • Costs are often lower than what an individual would pay on his or her own • Diversification is made easier	• Not guaranteed or insured by any bank or government agency • Always carry investment risks, with some types of greater risk than others • Typically a higher rate of return involves a higher risk of loss • Past performance is not a reliable indicator of future performance • All have costs that lower investment returns

Table 3.2

SIMILARITIES AND DIFFERENCES

Sub-advisor accounts and annuities are alike in some respects and differ in others.

Similarities	Differences
• Investing in either is easy • Both are easy to monitor • Both have professional management • Both have outstanding track records • Both offer investment options • Both provide options to increase the investment • Both provide options to withdraw funds • Both offer dollar cost averaging • Withdrawals and liquidation parameters are the same in mutual funds as they are in annuities	• Commissions • Taxation • Performance • Withdrawal options • Investment choices • Safety

Table 3.3

TAXATION

Income taxes are imposed on the following earnings:

- The dividends or interest generated by the securities;
- Capital gains from the sale of stocks or bonds (internal portfolio turnover);
- Profits received either upon the sale of shares or when changes are made within the account family.

Income tax is determined by the performance (amount of dividends, interest or capital gains) of the account, which is out of the investor's control and is subject to income tax. However, the investor can control the profit received upon the sale of shares or when changes are made within the account family. When the investor does sell shares, the gain is taxed as a capital gain (assuming they held the shares for 12 months or longer). Capital gains are taxed at a lower rate than ordinary income, so there is a better "end of rainbow" tax treatment than annuities.

On the other hand, investments in a fixed rate or variable annuity grow and compound while indefinitely tax-deferred. Profits are only subject to income taxes when withdrawals are made, and taxes are paid on that portion of the withdrawal that is considered accumulated growth and interest.

SUB-ADVISORY ACCOUNTS FOR VARIABLE ANNUITIES IN BOND INVESTING

A bond is a debt security, similar to an IOU. Borrowers issue bonds to raise money from investors willing to lend them money for a certain amount of time. When you buy a bond, you are lending to the issuer, which may be a government, municipality, or corporation. In return, the issuer promises to pay a specified rate of interest during the life of the bond and to repay the principal, also known as face value or par value of the bond, which it "matures," or comes due after a set period of time.

Sub-advisory accounts invest in bonds because:

- They provide a predictable income stream—typically, bonds pay interest twice a year;
- If the bonds are held to maturity, bondholders get back the entire principal, so bonds are a way to preserve capital while investing; and
- Bonds can help offset exposure to more volatile stock holdings.

Companies, governments and municipalities issue bonds to get money for various things, which may include:

- Providing operating cash flow,
- Financing debt, or
- Funding capital investments in schools, highways, hospitals, and other projects.

TYPES OF INVESTMENTS

- **Corporate bonds** are debt securities issued by private and public corporations.
- **Investment-grade bonds** have a higher credit rating, implying less credit risk, than high-yield corporate bonds.

- **High-yield bonds** have a lower credit rating, implying higher credit risk, than investment-grade bonds and, therefore, offer higher interest rates in return for the increased risk.
- **Municipal bonds** (aka "munis") are debt securities issued by states, cities, counties and other government entities. Types of municipal bonds include:
    - **General obligation bonds** – These bonds are not secured by any assets; instead, they are backed by the "full faith and credit" of the issuer, which has the power to tax residents to pay bondholders.
    - **Revenue bonds** – Instead of taxes, these bonds are backed by revenues from a specific project or source, such as highway tolls or lease fees. Some revenue bonds are "non-recourse," meaning that if the revenue stream dries up, the bondholders do not have a claim on the underlying revenue source.
    - **Conduit bonds** – Governments sometimes issue municipal bonds on behalf of private entities such as nonprofit colleges or hospitals. These "conduit" borrowers typically agree to repay the issuer, who pays the interest and principal on the bonds. If the conduit borrower fails to make a payment, the issuer usually is not required to pay the bondholders.
- **U.S. Treasuries** are issued by the U.S. Department of the Treasury on behalf of the federal government and carry the full faith and credit of the U.S. government, which makes them a safe and popular investment. Types of U.S. Treasury debt include:
    - **Treasury Bills** – Short-term securities maturing in a few days to 52 weeks.
    - **Notes** – Longer-term securities maturing within ten years.
    - **Bonds** – Long-term securities that typically mature in 30 years and pay interest every six months.
    - **TIPS** – Treasury Inflation-Protected Securities are notes and bonds whose principal is adjusted based on changes in the Consumer Price Index (CPI). TIPS pay interest every six months and are issued with maturities of five, ten, and 30 years.[11]

[11] SEC, https://www.investor.gov/introduction-investing/investing-basics/investment-products/bonds-or-fixed-income-products/bonds

KEY FEATURES

Individual bonds contain several features when issued: issue size and date, maturity date and value, coupon rate, and yield to maturity.

Issue size and date — The issue date is simply the date on which a bond is issued and begins to accrue interest. The issue size of a bond offering is the number of bonds issued multiplied by the face value.

Maturity date and value — The maturity date is the date on which an investor can expect to have their principal repaid. It is possible to buy and sell a bond in the open market prior to its maturity date, which changes the amount of money the issuer will pay the holder of the bond based on the current market price of the bond. Since bonds trade on the open market from their date of issuance until maturity, their market value will typically be different than the maturity value. However, barring a default, investors can expect to receive the maturity value at the specified maturity date, even if the market value of the bond fluctuates during the course of its life.

Coupon rate — The coupon rate is the periodic interest payment that the issuer makes during the life of the bond. For instance, if a bond with a $10,000 maturity value offers a coupon of five percent (5%), the investor can expect to receive $500 each year until the bond matures. The term “coupon” comes from the days when investors would hold physical bond certificates with actual coupons that they would cut off and present for payment. Since bonds trade on the open market, the actual yield an investor receives if they purchase a bond after its issue date (the yield to maturity) is different than the coupon rate.

Yield to maturity — Yield to maturity is a calculated estimate of the total amount of interest income a bond will yield over its lifetime. This is the value that most bond investors worry about.

BENEFITS AND RISKS

Bonds can provide a means of preserving capital and earning a predictable return. Bond investments provide steady streams of income from interest payments prior to maturity.

The interest from municipal bonds generally is exempt from federal income tax and also may be exempt from state and local taxes for residents in the states where the bond is issued.

As with any investment, bonds have risks. These risks include:

- **Credit risk** – The issuer may fail to timely make interest or principal payments and thus default on its bonds.
- **Interest rate risk** – Interest rate changes can affect a bond's value. If bonds are held to maturity the investor will receive the face value, plus interest. If sold before maturity, the bond may be worth more or less than the face value. Rising interest rates will make newly issued bonds more appealing to investors because the newer bonds will have a higher rate of interest than older ones. To sell an older bond with a lower interest rate, you might have to sell it at a discount.
- **Inflation risk** – Inflation is a general upward movement in prices. Inflation reduces purchasing power, which is a risk for investors receiving a fixed rate of interest.
- **Liquidity risk** – This refers to the risk that investors won't find a market for the bond, potentially preventing them from buying or selling when they want.
- **Call risk –** The possibility that a bond issuer retires a bond before its maturity date, something an issuer might do if interest rates decline, much like a homeowner might refinance a mortgage to benefit from lower interest rates.

FRAUD PREVENTION

Corporate bonds are securities and, if publicly offered, must be registered with the Securities and Exchange Commission. The registration of these securities can be verified using the Securities and Exchange Commission's EDGAR system. Consumers should be wary of any person who attempts to sell non-registered bonds.

Most municipal securities issued after July 3, 1995 are required to file annual financial information, operating data, and notices of certain events with the Municipal Securities Rulemaking Board (MSRB). If the municipal bond is not filed with MSRB, this could be a red flag.

PROTECTION FOR THE INSURER

When it comes to minimizing risk and increasing return, most variable annuities have inherent features designed for the insurer's protection.

A well-educated annuity professional should be experienced in providing the investor the goal for which he seeks. Their continuous research and constant monitoring

provide the right investments necessary to achieve the investor's objectives. Through diversification, risk is spread among many securities, reducing the possibility of losing a substantial amount of money due to any one security, a risk management strategy similar to a well-diversified mutual fund.

The investor's investment portfolio remains totally separate from the insurance company's general investment portfolio. Results in variable annuity portfolios are affected only by those investments held within the investor's portfolio.

THE PROSPECTUS

An insurance carrier must be registered with the Securities and Exchange Commission (SEC) to be able to offer variable annuities and must provide the investor, or prospective buyer, with a prospectus prior to the purchase.

In essence, the purpose of an annuity prospectus is to help consumers make an informed decision regarding the purchase of variable products.

An investment company prospectus contains important information about its fees and expenses, investment objectives, investment strategies, risks, performance, pricing, and more. Before investing in any traditional investment company—such as a mutual fund, closed-end fund, or unit investment trust (UIT)—the consumer should read the fund's prospectus and any other available information from the fund.

Insurance companies are required to file a preliminary and a final prospectus if they offer security investments (i.e., annuity, stock, bond). The preliminary prospectus contains the number of shares to be issued and/or price information. Typically, the preliminary prospectus is used to gauge interest in the market for the security being proposed. The final prospectus must contain the complete details of the product, such as:

- A summary of the company's background and financial information;
- The name of the company issuing the stock;
- The number of shares;
- Type of securities being offered;
- Whether an offering is public or private;
- Commissions and surrender charges;
- Names of the company's principals; and
- Names of the banks or financial companies performing the underwriting.

Below you'll find descriptions of the different types of information that investment companies provide to investors.

STATEMENT OF ADDITIONAL INFORMATION

The statement of additional information conveys information about the investment. The statement generally includes the financial statements and information (or additional information) about: the officers, directors and persons who control the investments; investment advisory and other services; brokerage commissions; tax matters; and performance measures, such as, average annual total return.

SHAREHOLDER REPORTS

Annual and semi-annual reports must be given to shareholders within 60 days after the end of the fiscal year and 60 days after the fiscal mid-year.

These reports contain updated financial information, a list of the portfolio's securities, and other information. The information in the shareholder reports will be current up to the annual or mid-year term.

STATUTORY PROSPECTUS VS. SUMMARY PROSPECTUS

There are two kinds of prospectuses: (1) the statutory prospectus; and (2) the summary prospectus. The statutory prospectus is the traditional, long-form prospectus with which most investors are familiar. The summary prospectus, on the other hand, is just a few pages long and contains key information about the investment.

Both kinds of prospectuses contain important information, including investment objectives or goals, its strategies for achieving those goals, the principal risks of investing, the fees and expenses, and its past performance. Investors can find more detailed information in the statutory prospectus, including information relating to the investment advisers and portfolio managers and details on how to purchase and redeem shares.

The Securities and Exchange Commission specifies the kinds of information that must be included in the prospectuses and requires key data to be included, such as fees and past performance, in a standard format so that investors can readily compare different investments.

COMPARING THE FIXED ANNUITY TO THE VARIABLE ANNUITY

Fixed vs. Variable	
Shared Characteristics	**Important Differences** (True of variable annuities, but not of fixed annuities)
• Retirement income is their primary purpose; • Purchase methods are the same; • The same types of annuity options; • The same concept of accumulation and annuity periods; • Partial surrender provisions; and • The guarantee of expense and mortality	• There is no guarantee of the principal, interest or the amount of payment; • The annuitant bears investment risks; and • Both state and federal government regulated.
Table 3.4	

A variable annuity offers a wide range of investment options. The value of the investment varies in accordance with the value of the total investment performance. If fixed annuities guarantee fixed monthly amounts, annuity monthly payments will vary and will depend on the performance of the investment options an annuity holder chooses. The fluctuation of the cash value and monthly income is the main difference between variable and fixed annuities.

The Pros and Cons of Variable Annuities	
Pros	**Cons**
• No contribution limits • Tax-deferred growth • Protection from creditors (most states) • Exempt from probate	• Can generate significant taxes • Usually come with high fees • Complex and difficult to understand
Table 3.5 [12]	

[12] Investopedia, *Variable Annuities: The Pros and Cons,* Aug. 2019

KEY POINTS TO PONDER

- Rebalancing is the process of realigning the weightings of a portfolio of assets.
- One of the most known risks with a variable annuity contract is the high fees carried.
- If money is withdrawn from a variable annuity within a certain period of time, the insurance company will assess a surrender charge.
- Rebalancing is the process of realigning the weightings of a portfolio of assets.
- Underlying investments in a fixed annuity are owned by the insurance company as part of its general account.
- With fixed insurance products, the insurance company assumes the investment risk.
- Drawbacks to the variable annuity include: poor cost basis, poor tax treatment for early withdrawals, high fees, complexity, contract fees and expenses, and potential loss of original investment.
- Yield to maturity is a calculated estimate of the total amount of interest income that is yielded over the investment's lifetime.
- The insurance company, rather than the contract owner, assumes the risk with fixed insurance products.
- The purpose of an annuity prospectus is to help consumers make an informed decision regarding the purchase of variable products.
- The main difference between variable and fixed annuities is the fluctuation of the cash value and monthly income.

CHAPTER 3 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. Who assumes the risk with fixed insurance products regarding payment of the rate of interest?

   a) The insurance company
   b) The contract owner
   c) The insurance agent
   d) The SEC

2. Who owns the underlying investments in a fixed annuity?

   a) The insurance company
   b) The contract owner
   c) The insurance agent
   d) The SEC

3. The process of realigning the weightings of a portfolio of assets is referred to as:

   a) reconfiguring.
   b) rebalancing.
   c) weighing
   d) equalizing

CHAPTER 4

IMMEDIATE OR DEFERRED – WHICH ONE?

The terms **immediate annuity** and **deferred annuity** are merely an indication of when the distribution phase of the annuity will begin. Both allow unlimited contributions, and both can provide a continuous stream of lifetime income. However, there are some key differences as well.

IMMEDIATE ANNUITIES

An immediate annuity begins making periodic payments quickly (within one year after purchase) to the annuitant right after the policy is issued. It is usually issued for a single lump sum premium that will give an annuitant and/or their spouse a guaranteed fixed payment. These payments may be monthly, quarterly or annually and are based on one's life expectancy or that of the annuitant and their spouse. An immediate annuity can provide income, in some cases, in as little as 31 days after purchase of the annuity.

For example, if the contract calls for monthly installments payments, they will begin one month after the date of purchase. Immediate annuities can be used as the sole source of income or as an income supplement. Payments may be made on a monthly, quarterly, or annual basis. The amount of the check the client receives will not fluctuate, and the actual dollar amount of the checks is in direct relationship to the total annuity investment.

An important note to remember: If the insurance company is going to begin paying the annuitant shortly after the purchase of the contract, then the immediate annuity must have been paid by a single payment, or all premiums must be received within a 30 to 45-day period immediately after the first premium is received.

ADVANTAGES OF IMMEDIATE ANNUITIES

Immediate annuities can provide the consumer with several advantages. First, and foremost, is guaranteed lifetime income.

Guaranteed Lifetime Income — This is the biggest advantage of an immediate annuity. With an immediate annuity payout option, the annuitant cannot outlive the income received from the annuity. Of course, this depends on that fact that the insurer remains solvent and able to fulfill this lifetime income promise.

Protection from Creditors — Many states allow the income received from an annuity to be shielded from creditors—in cases of financial hardship, and even in cases of bankruptcy. Remember, states vary in this regard.

Potential for Higher Returns — The immediate annuity can provide the potential of higher returns than other "safe" investments, such as bonds, CDs, and money market accounts. However, unlike annuities, the federal government protects CDs and bonds.

Exclusion Ratio — The exclusion ratio allows a certain percentage of the monies paid to the annuitant as a "return of principal." This money has already been taxed, and cannot be taxed twice. Because of this, immediate annuities will typically incur lower current tax when compared with other retirement vehicles such as a 401(k) or traditional IRA.

APPROPRIATE FOR THE CONSUMER

An immediate annuity can be an appropriate choice for someone who is new to retirement and has enough savings on hand that a large lump sum can be paid into the annuity for the purpose of generating lifetime income. Once the purchaser makes the payment to the insurance company, he/she no longer has to worry about it. The contract owner does not have to make any additional premium payments, and is guaranteed an income rate. The responsibility is no longer the contract owner's responsibility—the insurance company must make that money perform. Immediate annuities are specifically designed for those consumers who need to receive a specific amount of money each month.

IMMEDIATE VARIABLE ANNUITY

This type of annuity is unique. It still requires a lump sum payment and payments can begin almost immediately, as any immediate annuity. However, with this type of immediate annuity (immediate variable annuity), there is no guaranteed stream of income. Instead, the amount of income will depend on the performance of the portfolio's underlying investments. Depending on how the annuity is structured, payments to the annuitant will vary each month, or at least be reset annually.

Immediate variable annuities are designed to provide income that can rise over time to help keep pace with inflation.

However, immediate variable annuities carry the same risks as traditional variable annuities in respect to dropping performance value. If performance value decreases, so do the annuity payments.

Some of the benefits of immediate annuities are guaranteed income, the chance to earn money in the stock market, and a death benefit. The more guaranteed benefits that are added to a variable annuity contract, the higher the charges may be. The fees for immediate variable annuities vary by company.

Though other options may be cheaper, they are not as secure. Immediate variable annuities guarantee lifetime income, whereas IRAs or 401(k)s do not.

KEY QUESTIONS WHEN CONSIDERING AN IMMEDIATE ANNUITY

- How can the consumer benefit from this particular annuity?
- Will payments change if the financial market goes down?
- How soon can the consumer begin receive income payments?
- What happens to the money if the consumer passes away prematurely?
- Will income payments be taxed?
- Is there a limit to how many income payments the consumer can receive?[13]

DEFERRED ANNUITIES

A deferred annuity is one under which the annuity owner defers or delays receiving payments until a later date. A deferred annuity accumulates at interest for a specific period of time before the company begins making payments to the annuitant. It delays an annuitant's income stream, accumulating interest without earnings being taxed until withdrawn. People often purchase deferred annuities during their working years in anticipation of the need for retirement income later in their lives. Most deferred annuities provide a great deal of flexibility surrounding the timing and amounts of payout benefits. A deferred annuity can be paid for by a single premium, or annually, semi-annually, quarterly, or by monthly installments over a period of time.

[13] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

Unlike the immediate annuity, the deferred annuity payments to the annuitant begin after a designated period of time has elapsed from the purchase date. Most deferred annuities provide a great deal of flexibility surrounding the timing and amounts of payout benefits.

This type of annuity (deferred annuity) offers growth and flexibility over either a long or short period of time and can be purchased with a single premium, periodic premiums, or flexible premiums. The annuitant of a deferred annuity can elect to receive a certain dollar amount of income each year and can direct how the balance is to be reinvested. This deferral process gives the annuitant the flexibility of automatic reinvesting, withdrawal of a portion of the principal, or termination of the investment.

APPROPRIATE FOR THE CONSUMER

A deferred annuity can be an appropriate choice for someone who can afford to wait to receive the income generated by the annuity. Perhaps they have additional investment vehicles that will provide supplemental income during the annuity's accumulation phase.

The deferred annuity is appropriate for the consumer who wants to stay involved in the investment process—the contract owner can direct how the annuity balance is to be reinvested.

FIXED DEFERRED ANNUITY

A fixed deferred annuity is akin to a savings account. The annuity earns a modest rate of interest safely and postpones taxation on earnings until funds are withdrawn. The money in a fixed deferred annuity earns interest at a rate the insurer sets. The rate is fixed and won't change for some period of time. After that rate period ends, the insurance company will set another fixed interest rate for the next rate period. That rate could be higher or lower than the earlier rate.

Fixed deferred annuities provide a guaranteed minimum interest rate—the lowest rate the annuity can earn. It is stated in the contract and can't change for as long as the annuity remains in force.

The initial rate – The initial rate is an interest rate the insurance company may credit for a set period of time after the annuity is first purchased. The initial rate in some contracts may be higher than it will be later—often referred to as the bonus rate. The consumer should ask, "What is the rate?" and "How long until it will change?"

The renewal rate – The renewal rate is the rate credited by the company after the end of the initial set time period. The contract tells how the company will set the renewal rate, which may be tied to an external reference or index. The consumer should ask "When will it be announced?" and "How will the insurance company tell me what the new rate will be?"

Minimum guaranteed rate – The minimum guaranteed interest rate is the lowest rate the annuity will earn and is stated in the contract.

Most annuities have charges related to the cost of selling or servicing it, and fixed deferred annuities are no different in this regard.

For risk-adverse investors who will not need the interest income from their investment until age 59½ or later, the fixed deferred annuity may be a good fit.

VARIABLE DEFERRED ANNUITY

Investing in a variable deferred annuity is a lot like owning a group of mutual funds—the subaccounts. The contract owner has control over the amount of investment risk by choosing from a pre-selected list of subaccounts including both bond and equity investments. The interest on the variable deferred annuity is dependent upon the underlying investment performance.

For investors who will not need the interest income from their investment until age 59½ or later AND who want to take on the risk of managing the annuity's investment performance, the variable deferred annuity may be a good fit. This investor must seriously think about just how much risk they are willing to take on.

NAIC BUYER'S GUIDE FOR DEFERRED ANNUITIES

The NAIC publishes a buyer's guide to help consumers understand how annuities can be different from each other so they can choose the type of annuity that's best for their purposes and goals. The Buyer's Guide for Deferred Annuities provides information on the most common features of deferred annuities, as well as the common features shared by all deferred annuities, and the features that differ between deferred annuities. This is a good source of information for the consumer.

NAIC STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

Following is the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities regulation.

Section 2. Applicability. A. This Act shall not apply to any reinsurance, group annuity purchased under a retirement plan or plan of deferred compensation established or maintained by an employer (including a partnership or sole proprietorship) or by an employee organization, or by both, other than a plan providing individual retirement accounts or individual retirement annuities under Section 408 of the Internal Revenue Code, as now or hereafter amended, premium deposit fund, variable annuity, investment annuity, immediate annuity, any deferred annuity contract after annuity payments have commenced, or reversionary annuity, nor to any contract which shall be delivered outside this state through an agent or other representative of the company issuing the contract.

B. Sections 3 through 8 shall not apply to contingent deferred annuities.

C. Notwithstanding Subsection B, the commissioner shall have the authority to prescribe, by regulation, nonforfeiture benefits for contingent deferred annuities that are, in the opinion of the commissioner, equitable to the policyholder, appropriate given the risks insured, and to the extent possible, consistent with general intent of this law.

NONFORFEITURE REQUIREMENTS

Section 3 Nonforfeiture Requirements. A. In the case of contracts issued on or after the operative date of this Act as defined in Section 13, no contract of annuity, except as stated in Section 2, shall be delivered or issued for delivery in this state unless it contains in substance the following provisions, or corresponding provisions which in the opinion of the commissioner are at least as favorable to the contract holder, upon cessation of payment of considerations under the contract:

(1) That upon cessation of payment of considerations under a contract, or upon the written request of the contract owner, the company shall grant a paid-up annuity benefit on a plan stipulated in the contract of such value as is specified in Sections 5, 6, 7, 8 and 10;

(2) If a contract provides for a lump sum settlement at maturity, or at any other time, that upon surrender of the contract at or prior to the commencement of any annuity

payments, the company shall pay in lieu of a paid-up annuity benefit a cash surrender benefit of such amount as is specified in Sections 5, 6, 8 and 10. The company may reserve the right to defer the payment of the cash surrender benefit for a period not to exceed six (6) months after demand therefor with surrender of the contract after making written request and receiving written approval of the commissioner. The request shall address the necessity and equitability to all policyholders of the deferral;

(3) A statement of the mortality table, if any, and interest rates used in calculating any minimum paid-up annuity, cash surrender or death benefits that are guaranteed under the contract, together with sufficient information to determine the amounts of the benefits; and

(4) A statement that any paid-up annuity, cash surrender or death benefits that may be available under the contract are not less than the minimum benefits required by any statute of the state in which the contract is delivered and an explanation of the manner in which the benefits are altered by the existence of any additional amounts credited by the company to the contract, any indebtedness to the company on the contract or any prior withdrawals from or partial surrenders of the contract.

B. Notwithstanding the requirements of this section, a deferred annuity contract may provide that if no considerations have been received under a contract for a period of two (2) full years and the portion of the paid-up annuity benefit at maturity on the plan stipulated in the contract arising from prior considerations paid would be less than $20 monthly, the company may at its option terminate the contract by payment in cash of the then present value of the portion of the paid-up annuity benefit, calculated on the basis on the mortality table, if any, and interest rate specified in the contract for determining the paid-up annuity benefit, and by this payment shall be relieved of any further obligation under the contract.

MINIMUM VALUES

Section 4 Minimum Values. The minimum values as specified in Sections 5, 6, 7, 8 and 10 of any paid-up annuity, cash surrender or death benefits available under an annuity contract shall be based upon minimum nonforfeiture amounts as defined in this section.

A. 1. The minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to such time at rates of interest as indicated in Subsection B of the net considerations (as hereinafter

defined) paid prior to such time, decreased by the sum of Paragraphs (a) through (d) below:

(a) Any prior withdrawals from or partial surrenders of the contract accumulated at rates of interest as indicated in Subsection B;

(b) An annual contract charge of $50, accumulated at rates of interest as indicated in Subsection B;

(c) Any premium tax paid by the company for the contract, accumulated at rates of interest as indicated in Subsection B; and

(d) The amount of any indebtedness to the company on the contract, including interest due and accrued.

2. The net considerations for a given contract year used to define the minimum nonforfeiture amount shall be an amount equal to 87.5% of the gross considerations credited to the contract during that contract year.

B. The interest rate used in determining minimum nonforfeiture amounts shall be an annual rate of interest determined as the lesser of three percent (3%) per annum and the following, which shall be specified in the contract if the interest rate will be reset:

(1) The five-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or average over a period, rounded to the nearest 1/20th of one percent, specified in the contract no longer than fifteen (15) months prior to the contract issue date or redetermination date under Section 4B(4);

(2) Reduced by 125 basis points;

(3) Where the resulting interest rate is not less than one percent (1%); and

(4) The interest rate shall apply for an initial period and may be redetermined for additional periods. The redetermination date, basis and period, if any, shall be stated in the contract. The basis is the date or average over a specified period that produces the value of the five-year Constant Maturity Treasury Rate to be used at each redetermination date.

C. During the period or term that a contract provides substantive participation in an equity indexed benefit, it may increase the reduction described in Subsection B(2) above by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date, and at each redetermination date thereafter, of the additional reduction shall not exceed the market value of the

benefit. The commissioner may require a demonstration that the present value of the additional reduction does not exceed the market value of the benefit. Lacking such a demonstration that is acceptable to the commissioner, the commissioner may disallow or limit the additional reduction.

D. The commissioner may adopt rules to implement the provisions of Section 4C and to provide for further adjustments to the calculation of minimum nonforfeiture amounts for contracts that provide substantive participation in an equity index benefit and for other contracts that the commissioner determines adjustments are justified.

COMPUTATION OF PRESENT VALUE

Section 5 Computation of Present Value. Any paid-up annuity benefit available under a contract shall be such that its present value on the date annuity payments are to commence is at least equal to the minimum nonforfeiture amount on that date. Present value shall be computed using the mortality table, if any, and the interest rates specified in the contract for determining the minimum paid-up annuity benefits guaranteed in the contract.

CALCULATION OF CASH SURRENDER VALUE

Section 6 Calculation of Cash Surrender Value. For contracts that provide cash surrender benefits, the cash surrender benefits available prior to maturity shall not be less than the present value as of the date of surrender of that portion of the maturity value of the paid-up annuity benefit that would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender reduced by the amount appropriate to reflect any prior withdrawals from or partial surrenders of the contract, such present value being calculated on the basis of an interest rate not more than one percent (1%) higher than the interest rate specified in the contract for accumulating the net considerations to determine maturity value, decreased by the amount of any indebtedness to the company on the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract. In no event shall any cash surrender benefit be less than the minimum nonforfeiture amount at that time. The death benefit under such contracts shall be at least equal to the cash surrender benefit.

CALCULATION OF PAID-UP ANNUITY BENEFITS

Section 7 Calculation of Paid-up Annuity Benefits. For contracts that do not provide cash surrender benefits, the present value of any paid-up annuity benefit available as a nonforfeiture option at any time prior to maturity shall not be less than

the present value of that portion of the maturity value of the paid-up annuity benefit provided under the contract arising from considerations paid prior to the time the contract is surrendered in exchange for, or changed to, a deferred paid-up annuity, such present value being calculated for the period prior to the maturity date on the basis of the interest rate specified in the contract for accumulating the net considerations to determine maturity value, and increased by any additional amounts credited by the company to the contract. For contracts that do not provide any death benefits prior to the commencement of any annuity payments, present values shall be calculated on the basis of such interest rate and the mortality table specified in the contract for determining the maturity value of the paid-up annuity benefit. However, in no event shall the present value of a paid-up annuity benefit be less than the minimum nonforfeiture amount at that time.

MATURITY DATE

Section 8 Maturity Date. For the purpose of determining the benefits calculated under Sections 6 and 7, in the case of annuity contracts under which an election may be made to have annuity payments commence at optional maturity dates, the maturity date shall be deemed to be the latest date for which election shall be permitted by the contract, but shall not be deemed to be later than the anniversary of the contract next following the annuitant's seventieth birthday or the tenth anniversary of the contract, whichever is later.

DISCLOSURE OF LIMITED DEATH BENEFITS

Section 9 Disclosure of Limited Death Benefits. A contract that does not provide cash surrender benefits or does not provide death benefits at least equal to the minimum nonforfeiture amount prior to the commencement of any annuity payments shall include a statement in a prominent place in the contract that such benefits are not provided.

INCLUSION OF LAPSE OF TIME CONSIDERATIONS

Section 10 Inclusion of Lapse of Time Considerations. Any paid-up annuity, cash surrender or death benefits available at any time, other than on the contract anniversary under any contract with fixed scheduled considerations, shall be calculated with allowance for the lapse of time and the payment of any scheduled considerations beyond the beginning of the contract year in which cessation of payment of considerations under the contract occurs.

PRORATION OF VALUES; ADDITIONAL BENEFITS

Section 11 Proration of Values; Additional Benefits. For a contract which provides, within the same contract by rider or supplemental contract provision, both annuity benefits and life insurance benefits that are in excess of the greater of cash surrender benefits or a return of the gross considerations with interest, the minimum nonforfeiture benefits shall be equal to the sum of the minimum nonforfeiture benefits for the annuity portion and the minimum nonforfeiture benefits, if any, for the life insurance portion computed as if each portion were a separate contract. Notwithstanding the provisions of Sections 5, 6, 7, 8, and 10, additional benefits payable in the event of total and permanent disability, as reversionary annuity or deferred reversionary annuity benefits, or as other policy benefits additional to life insurance, endowment and annuity benefits, and considerations for all such additional benefits, shall be disregarded in ascertaining the minimum nonforfeiture amounts, paid-up annuity, cash surrender and death benefits that may be required by this Act. The inclusion of such benefits shall not be required in any paid-up benefits, unless the additional benefits separately would require minimum nonforfeiture amounts, paid-up annuity, cash surrender and death benefits.

SPLIT ANNUITY

A split annuity is actually an investment strategy (aka, "**laddering**") that contains two or more (usually two) fixed annuities working together—immediate and deferred. One annuity provides a monthly income for a defined time period while the other restores the original principal invested over the same period of time.

The strategy of a split annuity uses a single premium deferred annuity and a single premium immediate annuity. They are structured to produce immediate tax advantaged income for a guaranteed period of time and to also restore the original principal at the end of that time period. It's a contract by which the annuity owner "splits" his/her initial premium into two pieces, putting one part of the premium into a fixed deferred annuity with a guaranteed interest rate for a given term and putting the other part into an immediate annuity that pays an income for that same term.

It is usually structured where the deferred annuity grows back at the end of the guaranteed period to the total deposit originally invested, while receiving a guaranteed income from the immediate annuity throughout that same time period.

Example:

Susan divides $300,000 between an immediate annuity with a ten-year term and a deferred annuity with the same term. Assuming a five percent (5%) annual

return, Susan could collect monthly payments for ten years and, at the end, expect the account to be worth about what it was when she started.

In order to structure the annuity so it grows back into its original principal, the split may be uneven, with more directed to the deferred portion of the annuity.

ADVANTAGES OF THE SPLIT ANNUITY

Following is a list of **advantages** of a split annuity.

Dependable income — The immediate annuity can supplement one's income by providing a safe, predictable, and guaranteed cash flow. Depending on income needs, the immediate annuity can generate a stream of monthly income anywhere from five to twenty years.

Tax-advantaged income — Since a significant portion of their monthly income from the immediate annuity is considered a return of their original investment, it is tax-advantaged. In our example below, 81 percent of the monthly income payments would be tax-free.

Tax-deferred growth and principal preservation — The deferred annuity portion of the split annuity concept offers tax deferred growth and earns an interest rate that historically has been higher than average CD rates. In addition, their original principal is restored at the end of the guaranteed period, allowing them to start the process over again at prevailing interest rates. The funds placed in the single premium deferred annuity are available for emergencies with limitations.

Age limitations — In a split annuity, limits are placed on the ages at which policies can be issued, usually age 0-85 for nonqualified funds and 0-70 for qualified funds. The immediate income periods range from three to twenty years (3 to 20 years).

Split Annuity = Immediate + Deferred

QUESTIONS THE CONSUMER SHOULD ASK AND THE AGENT SHOULD ANSWER

- Do I understand the risks of an annuity? Am I comfortable with them?
- How will this annuity help me meet my overall financial objectives and time horizon?
- Will I use the annuity for a long-term goal such as retirement? If so, how could I achieve that goal if the income from the annuity isn't as much as I expected it to be?
- What features and benefits in the annuity, other than tax deferral, make it appropriate for me?
- Does my annuity offer a guaranteed minimum interest rate? If so, what is it?
- If the annuity includes riders, do I understand how they work?
- Am I taking full advantage of all of my other tax-deferred opportunities, such as 401(k)s, 403(b)s, and IRAs?
- Do I understand all of the annuity's fees, charges, and adjustments?
- Is there a limit on how much I can take out of my annuity each year without paying a surrender charge? Is there a limit on the total amount I can withdraw during the surrender charge period?
- Do I intend to keep my money in the annuity long enough to avoid paying any surrender charges?
- Have I consulted a tax advisor and/or considered how buying an annuity will affect my tax liability?
- How do I make sure my chosen survivors (beneficiaries) will receive any payment from my annuity if I die?[14]

[14] NAIC, Buyer's Guide for Deferred Annuities, https://www.naic.org/documents/prod_serv_consumer_anb_la.pdf

KEY POINTS TO PONDER

- The exclusion ratio allows a certain percentage of the monies paid to the annuitant as a return of principal.
- The guaranteed minimum interest rate is the lowest rate the insurance company will charge for administrative fees.
- The split annuity combines an immediate annuity and a deferred annuity.
- The terms “immediate annuity” and “deferred annuity” are merely an indication of when the distribution phase of the annuity will begin.
- Immediate annuities must be paid by a single lump sum payment or all premiums must be received within a 30- to 45-day period after the first premium is received.
- The exclusion ratio allows a certain percentage of the monies paid to the annuitant as a return of principal.
- An immediate variable annuity does not provide a guaranteed amount of income payments.
- An immediate annuity can be an appropriate choice for someone who is new to retirement and has enough savings on hand that a large lump sum can be paid to fund the annuity and generate lifetime income.
- The variable deferred annuity can be an appropriate choice for some who will not need income until retirement and wants to take on the risk of managing the annuity’s investment performance.
- A split annuity is an investment strategy that contains two annuities working together: immediate and deferred.
- With an immediate variable annuity, there is no guaranteed stream of income; income depends on the portfolio’s underlying investments.
- Fixed deferred annuities provide a guaranteed minimum interest rate.

CHAPTER 4 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. What do the terms “immediate” and “deferred” in the context of annuities actually mean?

   a) The terms are an indication of when the distribution phase of the annuity will begin.
   b) The terms refer to when the annuity was first purchased.
   c) The terms refer to the annuity’s payment schedule.
   d) The terms refer to whether the annuity was purchased in the insurer’s office or on the Internet.

2. The _____ allows a certain percentage of the monies paid to the annuitant as a “return of principal.”

   a) Cap Rate
   b) Exclusion Ratio
   c) Participation Rate
   d) Split

3. What is the main difference between the immediate annuity and the immediate variable annuity?

   a) With the immediate variable annuity, there is no guaranteed (fixed) amount of income as with the immediate annuity.
   b) With the immediate annuity, there is no guaranteed (fixed) amount of income as with the immediate variable annuity.
   c) The immediate variable annuity has no tax-deferral advantage like the immediate annuity does.
   d) The immediate annuity has no tax-deferral advantage like the immediate variable annuity does.

CHAPTER 5

INDEXED INSURANCE PRODUCTS

There are a wide variety of investment products that can help investors achieve their financial goals. Every investment product has its own general set of features including level of risk and anticipated returns. The main categories of investment products are:

- Stocks,
- Bonds,
- Mutual funds and ETFs,
- Insurance products such as variable annuities.

Risk and Return — Risk means how safe invested money will be and return is how fast invested money will grow. Generally, as investment risks rise, investors seek higher returns. Risk and return, however, aren't the only considerations when deciding what types of investment products to invest in:

- Fees (how much it costs to invest);
- Asset allocation (diversification of the overall financial situation);
- Liquidity (how easy it is to buy and sell the product); and
- Fraud (potential for investment fraud).

One of the most confusing aspects of index annuities is how the company calculates the interest rate that the policy will earn. The indexing method is the approach used to measure the amount of change, if any, in the index. Later, we will explore some of the most common indexing methods more fully.

HISTORICAL PERSPECTIVES – HYPOTHETICAL MODELS

Hypothetical illustrations are susceptible to manipulation in various ways. The most common way a hypothetical illustration can be manipulated is by "cherry picking" the period of time to illustrate. In theory a hypothetical return is an illustration of a "what-if" scenario that is "back tested" with some period of actual results. The hypothetical illustration usually compares two or more investment vehicles over the

same time period to show that one is superior to the other. When hypothetical illustrations are used in marketing literature, rest assured that the marketing department would never pick an unfavorable period of time to illustrate. Rather, they will pick the period that tells a happy story.

Actual Returns

A truer test of the anticipated future performance of a financial vehicle is the actual past performance of that same vehicle with all of the associated fees and expenses shown as well as illustrations of the “walk away” value the product owner was able to take with them, net of all transaction fees.

Renewal Rates

It is often asked why the caps on newly-issued policies are often different than renewal caps on older policies. This difference is primarily driven by the bonds that were purchased to back the policies. If, for example, interest rates have risen since a policy was issued, newly-issued policies will be supported by bonds that offer a higher yield. With higher yields, less money is needed to support the minimum guarantees and more money can be allocated to the purchase of index options. With more options, of course, higher caps can be offered on new policies than the renewals.

The reverse would be true in a falling interest rate environment; new policies would have less money allocated for option purchases, which would result in lower caps as compared to caps offered on renewals.

Option prices fluctuate year to year based on current market conditions, so if the price of options is higher in a given renewal year than what was assumed or budgeted at the time the policy was issued, fewer options can be purchased. The end result is that renewal caps on the policy will have to be lowered (fewer options purchased translates in to a lower cap). Conversely, lower option prices result in higher renewal caps.

Popularity of Indexed Products

Indexed insurance products are increasingly popular with the public. As with all cash value insurance products, fixed indexed insurance products offer a combination of insurance and investment features.

Fixed indexed insurance products are a natural evolution of the traditional fixed insurance product, which offers one method of crediting interest. Fixed indexed insurance products are nothing more than a traditional fixed insurance product that offers owners an opportunity, often on an optional basis, to receive interest based on positive changes in a financial markets index coupled with insurance guarantees of purchase payments and minimum rates of interest. In other words, fixed indexed insurance products offer guaranteed preservation of purchase payments coupled with guaranteed growth in value, even when indexed-based interest is small or non-existent.

Since indexed products are relatively young, new features will be added and products enhanced and/or changed. More crediting strategies will likely evolve and more indices will be used. Deferred income annuities (DIA) offer a guaranteed lifetime income benefit, providing a lifetime annual income while maintaining access to the money. The following provides examples of the features a deferred income annuity might include.

- **Guaranteed Lifetime Income Benefit**
  - Activate at any time after age 59½ (and after the first contract year).
  - Provides a guaranteed annual income you can systematically withdraw for as long as you live, even if the contract value falls to zero.
  - Contract value continues to receive positive indexed interest gains even after electing to begin the guaranteed lifetime income benefit.
- **Guaranteed Lifetime Income Account Value**
  - Includes a 10% bonus applied to the initial premium received.
  - Guaranteed to be at least 10% of the premium, less prior withdrawals, accumulated at five percent (5%) interest on the date the benefit is exercised.
  - Opportunity to receive annual indexed interest gains based on change in the Standard & Poor's 500 Index.
  - 100% participation with no annual caps and no annual fees, all guaranteed for ten years.
- **Guaranteed Lifetime Annual Income**
  - Equal to five percent (5%) of the guaranteed lifetime income account value on the day you activate the benefit.

- Should the contract value exceed the value of the guaranteed lifetime income account, a 10% step up benefit will provide at least 10% additional guaranteed income for life.

- **Expansion of Index Crediting**
  - Indexing interest crediting is now being used on immediate annuities with choice of index, crediting strategies and fixed account guarantees.

THE PROS AND CONS

One advantage of an indexed product is the potential for higher interest crediting rates than a traditional universal product. Another advantage is that it offers greater protection from market downturns than a variable product. These products can offer some peace of mind to buyers looking for a mix of guarantees and some potential for cash accumulation.

However, there can be disadvantages of having an indexed product. The chief disadvantage of an indexed product is that it comes equipped with slightly higher risk than a traditional universal product. Also, the cap rate—the maximum rate you may earn—limits the upside potential compared to a variable product, and may be changed periodically by the insurance company. The crediting rate system in these products is probably not familiar to would-be buyers and agents. Since the concept is new and there are so many “moving parts” to one of these products, it is sometimes difficult to figure out what the product actually does at first.

These products do fill a void between the traditional bookends of the modern insurance marketplace, but it would be an overstatement to term them the best of both worlds. They have neither the appealing guaranteed rates of universal life nor the true market participation of variable life. However, they do offer an attractive third option for buyers and may be ideal for a segment of the population whose needs have been overlooked by existing insurance products.

INTEREST INDEXED ANNUITIES

“Interest indexed annuity contract” means an annuity contract where the interest credits are linked to an external reference.

An indexed annuity is a type of tax-deferred annuity whose credited interest is linked to a market index. (Note that the term “equity-indexed annuity” has been removed to help prevent incorrect assumptions.)

All indexed annuities typically carry some common traits:

- Variable, index-linked yield,
- Crediting method,
- Minimum guaranteed rate, and
- Tax-deferral.

During the **accumulation phase**, a series of payments (or lump sum) is paid to the insurance company. These payments can be allocated to one or more indexed investment options. The insurance company credits the account with a return that is based on the indexed investment option's return. During the **annuity phase**, the insurance company makes periodic payments to the annuitant. Or, they can choose to receive the contract value in one lump sum.

Depending on the circumstances, an indexed annuity may or may not be a security. If an indexed annuity is a security, it is regulated by the SEC. All indexed annuities are also subject to state insurance regulation. If an indexed annuity is not a security, it will not be regulated by the SEC, but would still be subject to state insurance laws.

Indexed annuities were established in the mid-1990's by insurance companies to compete with very popular indexed mutual funds. An indexed annuity is different from other fixed annuities in the way it credits interest to an annuity's value. This annuity earns interest that is linked to a stock or other index, such as Standard & Poor's 500 Composite Stock Price Index (the S&P 500).

Indexed annuity contracts describe both how the amount of return is calculated and what indexing method is used. Based on the contract terms and features, an insurance company may credit the indexed annuity with a lower return than the actual index's gain. If the annuity exposes investments to some risk of loss, the annuity owner could lose more money in an indexed annuity when the market index goes down than the index loses.

Most fixed annuities only credit interest calculated at a rate set in the contract. Indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest the contract owner receives and when they get it depends on the features of their particular annuity.

Many indexed annuities, like other fixed annuities, also promise to pay a minimum interest rate. The rate that will be applied will not be less than this minimum

guaranteed rate even if the index-linked interest rate is lower. The value of this annuity also will not drop below a guaranteed minimum.

The designated time period for an indexed annuity is usually seven years (or longer). Many insurance companies have noted the benefits of long-term investment in indexed annuities.

- A risk-free CD alternative;
- Potential to have current credited interest linked (indexed) to equity performance without investing in equities;
- Both growth and safety in the same tax-deferred vehicle;
- If the market goes down, the investor gets all of the principal back at the end of the term;
- If the chosen index goes up, the investor gets all of the principal back at the end of the term PLUS current interest, determined using the index performance as a metric in the interest calculation formula.

The indexed annuity in its simplest form provides the long-term potential growth of the stock market. This means that the interest rate set by the insurance company at the end of each policy year is based on the index performance.

It also provides the downside guarantees of an annuity. This means that once an annuity owner makes a premium payment, they will never have less in their account than their premium payment. Once interest has been credited to the annuity, the value of the annuity will never decrease (unless a withdrawal is made) even if the stock market goes down.

Two features that have the greatest effect on the amount of additional interest that may be credited to the annuity are the indexing method and the participation rate. It is important to understand these features and how they work together.

One of the most confusing aspects of indexed annuities is how the company calculates the interest rate that the policy will earn. The indexing method is the approach used to measure the amount of change, if any, in the index. (Indexing methods will be discussed in detail later in the course material.)

There are several methods that may be used; however, all methods essentially measure the change in the S&P 500 Index over some period of time. The time periods that companies use are either the **policy year**, from the day the policy is issued to one year later; or a **specific term**, a period of one or more years. To better understand these terms (“policy year” and “specific term”) here are some examples.

Example of Policy Year:

The S&P 500 was at 500 on the day Jim's contract was issued, and during the **policy year** of the contract the highest point the S&P 500 reached was 550. The gain of 50 points represents a 10% increase; therefore the value of Jim's contract would be increased by 10%. An annuity policy with an initial premium of $100,000 one year later would be credited with $10,000 of interest.

Example of Specific Term:

The S&P 500 was at 500 on the day Jim's contract was issued, and over the five-year term of his contract the highest point the S&P 500 reached was 700. The gain of 200 points represents a 40% increase; therefore the value of the contract would be increased by 40%. An annuity policy with an initial premium of $100,000 five years later would be credited with $40,000 of interest.

Note: *Both the specific term and policy year method examples above use the* ***High Water Mark*** *method in determining how much interest the policy earned.*

CALCULATING THE RETURN – GAIN VS. LOSS

An indexed annuity generally promises to provide a return linked to the performance of an index. If the index has a gain, the contract value of the indexed annuity will also increase. But the indexed annuity may be credit with a return that is lower than the index's return.

An indexed annuity generally promises to provide a return linked to the performance of an index. If the index has a gain, the contract value of your indexed annuity will also increase. But your indexed annuity may be credited with a return that is lower than the index's return for many reasons.

Dividends are usually excluded. Any gains in the value of the index are generally calculated without including dividends paid on the securities that make up the index. For example, a specific market index reports a total return of 7% one year, but 2.5% of those returns are from dividends. Many indexed annuities would consider 4.5% to be the index's return when calculating any gains to your indexed annuity (7% - 2.5% = 4.5%).

Only a portion of the performance of the index is usually included. Indexed annuities typically use one or more features that restrict the positive return that is applied to your annuity contract value. Some common indexing features include the following.

- **Participation Rate**. The participation rate determines how much of the gain in the index will be credited to the annuity. For example, if the participation rate is 75% and the index return is calculated to be 10% during the measuring period, the return credited to the annuity would be 7.5% (10% x 75% = 7.5%).
- **Rate Cap**. The rate cap is a maximum rate of positive return that your contract can earn. For example, if the contract has an upper limit, or cap, of 7% and the index return is calculated to be 12%, only 7% would be credited to the annuity.
- **Margin/Spread/Asset or Administrative Fee**. This fee subtracts a set percentage from any gain in the index. It is sometimes called the "margin," "spread," "asset fee," or "administrative fee." In the case of an annuity with a "spread" of three percent (3%), if the index return were calculated to be nine percent (9%), the return credited to the annuity would be six percent (9% - 3% = 6%).

Some indexed annuities combine these features. For example, if an indexed annuity uses both a participation rate of 75% and a "spread" of three percent (3%) and the index return is calculated to be 10%, the return credited to the annuity would be 4.5% (10% x 75% = 7.5%; 7.5% - 3% = 4.5%).

These features reduce the return in the same way that a direct fee would, even if the annuity is called a "no fee" annuity.

Some indexed annuities specify that investors may lose money if the market index goes down in value. If they do, the indexed annuity may offer some limited protection against that risk. Some common protections include:

Floor. This protection limits investor exposure to a set percentage of potential loss. For example, if the floor is 10% and the index decreases by 12%, the annuity would only lose 10% of the annuity contract value, before considering any adjustments imposed by contract terms such as surrender charges.

Buffer or Shield. This protection offers a set percentage of loss that the insurance company is willing to absorb before deducting value from the indexed annuity. For example, if the shield is 10% and the index decreases 12%, the annuity would only lose two percent (2%) of the annuity contract value, before considering any adjustments imposed by contract terms such as surrender charges.

Different indexed annuities use different indexing methods. Indexing methods determine how the change in the variable annuity's return is determined at the end of each time period. This return is then applied to the indexed annuity, as discussed above.

An indexed annuity can lose money in several ways.

Withdrawals during a specified time period. If money is taken out of the indexed annuity before the end of a time period, not all of the return from that time period may be applied to the annuity. In addition, some of the principal invested may be lost in certain indexed annuities if amounts are withdrawn before the end of a time period, depending on the value of the market index at the time of the withdrawal.

Surrender charge. If all or part of the money is taken out during the surrender period, the contract owner may have to pay a surrender charge. The surrender period is a set period of time that typically lasts six to ten years, or even longer, after purchase of an annuity. Surrender charges will reduce the value and the return of investment.

Tax penalty. Under current tax law, if all or part of the money is taken out from tax-deferred indexed annuities before the annuitant reaches the age of 59½, the 10% federal tax penalty will most likely apply.

Market index drop. Money may be lost in some indexed annuities if the market index goes down.

Insurance company failure. Many indexed annuities promise to make payments many years into the future. But remember that all amounts payable are subject to the ability of the insurance company to pay. Circumstances may arise where the insurance company is unable to pay its obligations.[15]

THE PARTICIPATION RATE

The participation rate determines how much of the index increase will be used to calculate the index linked interest to be credited to a contract for that year. For example, if the calculated change in the index is nine percent (9%) and the participation rate is 70%, the index linked interest rate for the annuity will be 6.3 percent (9% x 70% = 6.3%). 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.

[15] SEC.gov, Investor Bulletin: Indexed Annuities, Aug. 13, 2019, https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_indexedannuities

Example:

Susan has a $100,000 indexed annuity linked to the S&P 500 with a 70% participation rate. If the S&P 500 experiences a 10% growth, her account will be credited with 70% of that 10% growth, giving the annuity a 7% interest rate for the year. Susan's annuity account value would now be $107,000. However, if it were invested in the S&P 500 directly, her account would be worth $110,000.

Even though the indexed annuity grew at a lower rate, Susan was afforded downside protection. If in the following year, the S&P 500 declined by five percent (5%), the annuity's value would remain at $107,000 because gains are locked in each year. The value of the direct S&P 500 investment account would fall to $104,500.

The company usually guarantees the participation rate for a specific period (from one year to the entire term). 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.

Every indexed annuity features a minimum rate of return regardless of index performance. This rate is the insurance, and it varies from contract to contract from one to three percent (1%- 3%). The minimum rate guarantees that whenever the index decreases in value, the annuity will still earn.

The participation rate may vary greatly from one annuity to another and may also vary from time to time within a particular annuity. Therefore, it is important for one to know how their annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as "**averaging**" or a "**point-to-point**" indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an "**annual reset**" indexing method.

The Participation Rate:

- **Sets portion of index movement used in indexing formula**
- **Can usually change during life of contract**
- **Set in advance for the upcoming contract year**

THE CAP RATE

The cap rate is usually a “moving part.” Some annuities put an upper limit, or cap, on the index-linked interest rate. This limit is the **maximum rate of interest** the annuity will earn, regardless of the performance of the index. In the previous example, if the contract has a six percent (6%) cap rate, six percent (6%), and not 6.3%, would be the amount of interest credited to the annuity. Not all annuities have a cap rate.

While a cap limits the amount of interest earned each year, annuities with this feature may have other more desirable features as well, such as annual interest crediting or the contract owner’s ability to take partial withdrawals. Annuities that have a cap may also have a higher participation rate. The cap rate, though it is one of those “moving parts.” it is guaranteed to never drop below zero percent (0%). There is usually no maximum cap rate guarantee.

- **Upper limit is the Cap Rate**
- **Limits rate credited to annuity**
- **Applied to result of indexing formula**
- **Set in advance for the upcoming contract year**

FLOOR RATE ON INDEXED-LINKED INTEREST

The floor rate is also a “moving part.” Since many fixed indexed annuities guarantee a minimum interest rate regardless of the performance of the index, the floor rate will only be found in annuities that do not guarantee a minimum interest rate. The floor rate will state that the annuity will be credited with a minimum rate of return regardless of index performance. When a floor rate is present, it is usually guaranteed to never fall below zero.

- **Most common floor is 0%**
- **Sets bottom level of indexed linked interest**
- **Assures no negative return**

DISADVANTAGES OF INDEXED ANNUITIES

All investments come with advantages and disadvantages, including stocks, CDs, and mutual funds—and indexed annuities are no exception.

EARLY WITHDRAWAL PENALTY

Although indexed annuities insure against loss of principal, early withdrawals may forfeit a large portion of the earnings. Withdrawing annuity funds prior to age 59½ results in a 10% IRS tax penalty. This drawback will affect any consumer who is looking for pre-retirement income. Don't invest short-term and don't invest too young!

- **Investing Short-Term** — Indexed annuities are savings instruments especially well-suited for retirement income, when needed the most. The biggest indexed annuity investment mistake is investing money needed to make ends meet, increasing the likelihood of early withdrawals and incurring associated penalties.
- **Investing Too Early** — Some experts say that investing in any type of annuity before the age of 30 is not a good idea. Just like a 401(k) or IRA, an indexed annuity comes with disincentives for pre-retirement withdrawals. The only way to avoid the 10% deduction for premature withdrawals is by waiting until retirement to start taking withdrawals. If the consumer has no intention of waiting, they should consider alternative investments like certificates of deposit or mutual funds.

PARTICIPATION RATE AND RATE CAP

A low participation rate means the insurance company takes a larger cut of the profits. The participation rate should be fixed throughout the full contract term. Some indexed annuities cap the maximum annual yield. "No-Cap" or high cap annuities are always preferred. A common pitfall when shopping for indexed annuities is either getting stuck with a very low cap, or sacrificing more important factors (like the participation rate) for an excessively high cap.

The single most important factor of an indexed annuity contract is the participation rate—the portion of raw index growth that gets credited to the annuity account. The higher this rate, the higher the effective annual yield. A low participation rate means the insurance company takes a larger cut of the profits. The participation rate should be fixed throughout the full contract term. Some indexed annuities cap the maximum annual yield. "No-Cap" or high cap annuities are always preferred. A common pitfall when shopping for indexed annuities is either getting stuck with a very low cap, or

sacrificing more important factors (like the participation rate) for an excessively high cap.

Annual Reset Provision

Be aware – As long as the indexed annuity zeros out every year, the account balance can't drop below its previous high. Although point-to-point or high water mark crediting methods have their attributes, it's generally advisable to stick with an annually resetting indexed annuity. This provision—the annual reset— means that any growth experience during the current year gets locked in, setting the baseline for the next year's calculation. With annual reset, if the S&P 500 goes red after a previously positive year, the previous year's earnings never erode. Instead, the insurer is obligated to pay the minimum guaranteed rate. "Automatically secured earnings" is a feature of no other investment vehicle.

Partially Guaranteed Rates

When comparing similar indexed annuities, the guarantees on important provisions must be written and documented in the annuity contract. For instance, a 90% participation rate may be "guaranteed," but for how long? A contract with a full-term guaranteed 70% participation rate is actually preferable to a 90% participation rate that's only guaranteed for the first year. A partially guaranteed rate isn't necessarily a reason NOT to purchase as long as the rate has a reasonable floor after the guarantee expires. Avoid contracts without floors.

Taxation Consequences

Gains in annuities are not considered capital gains. Capital gains rate is substantially lower than ordinary income taxes. Although tax-deferred in the beginning, income is eventually taxed at ordinary income rates, unlike stocks or mutual funds. With annuities, income is taxed only after withdrawal, allowing the annuity to earn compound interest that would have otherwise gone to the IRS if invested in mutual funds, CDs, or stock. Because indexed annuities are typically held for many years, compound interest on deferred tax payments can add up substantially.

Administration Fees

Annuity management fees can range from one to three percent (1% to 3%). This percentage is deducted from the annuity account every year. Fees are deducted prior to crediting and regardless of market performance. Administrative fees may be fixed or variable. Consumers should look for the lowest fees and make sure they are fixed.

Withdrawal Fees

Withdrawals exceeding the annual allowance incur a penalty charge directly from the insurance company. Withdrawal fees are usually five percent to ten percent (5% to 10%) on any type of annuity. Annuity contracts, however, detail a maximum penalty-free amount that can be withdrawn on an annual basis. Withdrawals over the allowance are then subject to fees. However, these fees decrease as time goes by and eventually are phased out entirely.

Calculating the Growth

Consumers should be aware of how the annuity calculates growth (i.e., annual averaging, monthly averaging, point-to-point, etc.). All have their pros and cons.

As a general rule, the insurance company credits an index annuity account on an annual basis, unlike a mutual fund or variable annuity, which can grow on a daily basis. With indexed annuities, as the anniversary date approaches, the insurance company will calculate the annual yield either using the year-to-date calculation, or the yearly average calculation.

A year-to-date calculation simply takes the value of the S&P 500 (or whatever the index may be) at the previous anniversary date and subtracts it from the current. The percentage differential equals the gross annual yield. Notice how the S&P's ups and downs between these dates are irrelevant.

A yearly average calculation averages out the performance of the S&P 500 the anniversary dates. The gross annual yield equals monthly performance divided by 12. Notice that averaging reflects the month-to-month fluctuations of the index.

Vesting Schedule

Earnings diminish when withdrawn early. A vesting schedule determines by exactly how much. Unlike other annuities, indexed annuities take a portion of the account earnings if withdrawals are made early. The vesting schedule outlines how much of the earnings are retained and how much can be withdrawn penalty-free. Don't invest in an index annuity if you're uncomfortable with its vesting schedule.

Key Questions When Considering an Indexed Annuity

- How long is the term of the indexed annuity?
- What penalties will be incurred if money is removed early?

- What indexing method is used with the annuity?
- What is the annuity's interest rate cap?
- What is the annuity's participation rate?[16]

ANNUITY INDEXING METHODS

An indexed annuity earns interest that is linked to a stock or other index, such as Standard & Poor's 500 Composite Stock Price Index (the S&P 500). There are a number of different indexes used in indexed annuities, and often the annuity owner can allocate funds within the annuity among several different indexes concurrently.

The amount of interest credited to a fixed indexed annuity is determined by a formula applied to one or more external indexes. This formulaic approach to calculating interest is usually called the indexing method, and there are several indexing methods that are used.

Most of the indexing methods have fluctuating parts, which are values within the indexing calculation that can be adjusted periodically by the insurer. These fluctuations within the formula are usually guaranteed by the insurer to stay within a certain range (minimum and maximums) for the lifetime of the annuity; and can only be adjusted by the insurer on a forward-looking basis. For example: One of the fluctuating parts is often a cap rate. If a particular fixed indexed annuity has an indexing period of one year, the company must set the cap rate (if any) at the beginning of the indexing year and cannot change that particular feature until the end of the current indexing year. Another way to put it is that the insurer cannot change a "moving part" on a retrospective basis.

HOW RATES ARE CREDITED

Many factors are considered when determining credited interest rates:

- The company's net earnings rate expected (the gross earnings rate less investment expenses) on the portfolio of assets supporting the product;
- The net earnings rate on new money being invested in that portfolio of assets supporting the product;
- Credited rate methodology (i.e., new money vs. portfolio approach);

[16] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

- The desired interest margin, which is the difference between the company's net earnings rate and the credited interest rate to support the product pricing;
- Actual vs. assumed experience of other factors, such as persistency, mortality, and expenses;
- Credited interest rates on other products within the company and by the competition;
- Whether the current interest rate is indexed or declared, and how often it's subject to change;
- The "floor" guaranteed interest rate on the product;
- The product's loading structure (front-load vs. back-end load);
- The level of risk associated with the product.[17]

PERCENTAGE CHANGE

The first and nearly universal adjustment is a floor or minimum of zero percent (0%) on the index value change percentage. This prevents a negative interest credit from ever occurring. It effectively locks in prior interest credits by keeping them from being invaded by a future negative credit. Indexed approaches with this feature are referred to as "ratchet" approaches, because policy values can go in only one direction (up) as a result of interest credits. A few products have a higher floor than zero percent (0%).

The change in the S&P 500 Index from the beginning of the term to the end of the term is expressed as a percentage. The term could be one policy year, five policy years or seven policy years, etc. If the Standard & Poor's 500 was 500 at the beginning of the policy year and closed at 550 at the end of the policy year, there would have been a 10% increase in the S&P 500 Index. In years where the S&P 500 Index is negative, the percentage credited to their policy is zero (0). In this case, there would be no change in their policy value.

There are a variety of methods of determining the percentage change. The term of the interest credit is usually annual but may be any number of years. (The **indexed value percentage change** is typically abbreviated as IVPC.)

Indexed interest approaches use various methods of determining what index value is used for any particular date. For example, some insurance companies use the first

[17] Annuity Financial, *How Rates are Credited*, 2012

available index value after the policy anniversary if there is not one available, because the date is a holiday or non-market day.

At the end of a term, a credit is made. Therefore, most products start anew with an interest crediting term of the same length. For example, if a product has an annual term and the ending index value of the prior term becomes the beginning value of the next term, the product is said to be an “annual reset” calculation, because the beginning index value is reset at the beginning of the next term to where the index finished in the last term.

An index value is a number measuring the value of a specified group of stocks, bonds or other financial instruments. Many indexed products specify the Standard & Poor’s 500 Composite Stock Price Index, which does not reflect dividends (the S&P 500 Index). Currently, insurance companies use less than a dozen other indexes. Some fixed indexed products specify only one index, but some permit an owner to choose among several approaches and reallocate among indexes as well as declared-rate fixed account at the end of interest crediting terms.

A fixed annuity has no direct participation in any other investment. Regardless of how an insurance company hedges or assures itself of having funds available to provide the interest credit, it is guaranteed to be paid by the company. This method credits a percentage or proportion of the index value change percentage as interest. For example, an 80% participation rate applied to an index value change percentage of 10% will yield a credit of 8%. When interest rates are low or hedge costs are high, participation rates will usually be less than 100% and vice versa. Should the product allow the insurance company to change participation rates for future interest terms, they must state a minimum guaranteed level of participation rate, e.g., .25 percent (0.25%). Adjustments to the full upside are necessary because rarely would the cost of providing the underlying guarantees leave enough available to exactly match the full upside potential. How much upside can be purchased depends on the rate of return on the underlying assets (bonds), the guarantee that is being provided and volatility of market.

The company does not invest financial assets in the instruments making up the index. The carrier invests primarily in bonds to provide the underlying guarantees as well as other financial instruments (or hedging strategies) that provide the pre-stated portion of the index return that the client will receive.

Almost always mid-term withdrawals or partial surrenders will not earn interest credit for period during which it was withdrawn or surrendered. The withdrawal or surrender amount and any surrender charges will be deducted from the account value before the interest earned for the term is credited. Minimum nonforfeiture or minimum

guarantee is a specified percentage of total purchase payments (ranging between 87.5% and 100% of purchase payments, thereby generally reflecting the deduction of expenses and less any withdrawals), which is referred to as “principal;” plus a guaranteed rate of interest in the form of a minimum rate of interest required under applicable state insurance nonforfeiture laws (historically and currently, three percent (3%) annually, but, at times, ranging between one percent and three percent (1% and 3%) depending on the then-current yield curve as indexed to five-year Treasury yields), which becomes part of the principal. This is commonly referred to as the minimum guaranteed account value. However, in addition to the minimum guarantee the principal may earn a rate of interest (sometimes referred to as the “excess rate interest”) that is calculated under a guaranteed formula by reference to an index, which becomes part of the principal and may be thought of as the premium accumulation value, which is typically referred to as the current account value. The owner’s account value will be the greater of the minimum nonforfeiture value or premium accumulation value less any withdrawals, surrenders or surrender charges.

THE NATIONAL ASSOCIATION OF FIXED ANNUITIES WEIGHS IN

The National Association of Fixed Annuities (NAFA) states its concern with any historical analysis that is used primarily to determine product performance because you cannot economically, actuarially and mathematically recreate the volatility formulas used to price the index options, the investment portfolio used to determine the share of expenses for option purchases and guaranteed benefits, the general expense formula for the product, and the companies profit requirement. NAFA states that simply recreating a historical reconstruction of the index performance and applying that to a crediting methodology cannot and should not be used to inform the customer of potential performance.

NAFA believes that selling these products based on backdating performance inappropriately assigns performance as the main reason to buy a fixed indexed annuity. NAFA believes fixed indexed annuities should be purchased by individuals who want to use the unique combination of insurance and investment features that they offer—guaranteed principal protection, guaranteed prior earnings protection, guaranteed minimum interest, and tax deferred savings. Fixed indexed annuities can be a useful retirement planning tool for unsophisticated purchasers and retirees or those close to retirement who, probably more than others, cannot risk losing their principal and need some predictable guarantee of increases. The insurance element of minimum guarantee results in a predictable asset to fund the future liabilities of a person’s retirement years. This minimum floor is coupled with the upside potential of additional credited interest based on increases in an index.

FIXED INTEREST RATE

Most fixed indexed annuities allow the annuity owner to allocate part or all of their annuity values to a fixed interest bucket where the fixed rate is announced in advance and guaranteed for the year. This is very similar to a traditional fixed annuity.

INDEXED CREDITING STRATEGIES

Typical Indexed crediting strategies include:

- One year point-to-point (a two-year point-to-point may be used by some products);
- One year monthly average using multiple Indices or a single index;
- One year monthly average;
- One year monthly cap; and…

…In addition, many products have a fixed interest for a specified period of time often one, two and five years.

A specific product may use one, two or all of these strategies. Policyowners with a multiple crediting strategy product may also use one, two or any number of the strategies.

AVERAGING METHOD

The averaging method compares an average of the index levels at periodic intervals during the time period to the index level at the beginning of the time period. The averaging method of indexing calculates the change in the indexing by averaging the closing index values for the same day each month during the index term. If the index term were one year, the insurer would add the closing index values for each of the twelve months during the index term and divide by twelve. The result of this calculation would be used as the ending value of the index and then compared to the index value at the beginning of the index term to determine percent change in the index.

Below is an example of the monthly averaging indexing method using the following assumptions:

- The first of each month is the measurement day;

- Indexing term is one year.

(For illustration, all index values are only expressed in whole numbers and calculation is not carried beyond three decimal positions.)

Date	Month	Index Value
January 1	Begin	1,000
February 1	1	1,014
March 1	2	1,020
April 1	3	1,033
May 1	4	1,066
June 1	5	1,019
July 1	6	1,024
August 1	7	1,033
September 1	8	1,056
October 1	9	1,064
November 1	10	1,038
December 1	11	1,044
January 1	12	1,061
Total of 12 Monthly Index Values		12,472
Average of 12 Monthly Index Values		1,039

Table 5.1

Note: This example is for agent use only and is not to be used with consumers. This is only an illustration for understanding how annual point-to-point indexing works and is not a representation of past history or a prediction of the future movement of any index.

In the example above the average of the 12 monthly index values is 1,039, and this number would be used as the ending index value in the calculation. The interest credited would be as follows: Ending index value divided by beginning index value, minus 1:

Step 1: 1,039 ÷ 1,000 = 1.039

Step 2: 1.039 – 1 = .039 or 3.9%

Unless there is a participation rate, cap rate, or spread/margin/asset fee that limits the calculation, the annuity would be credited with 3.9 percent (3.9%) interest for the year.

The averaging method also tends to lower the overall rate of return of the S&P 500 Index, similar to that of a "cap." In rising markets, the averaging method limits the increase that would be credited to the annuity policy.

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.

Averaging at the beginning of a term protects one from buying their annuity at a high point, which would reduce the amount of interest they might earn. Averaging at the end of the term protects them against severe declines in the index and losing index linked interest as a result. On the other hand, averaging may reduce the amount of index linked interest earned when the index rises either near the start or at the end of the term.

DAILY AVERAGING

In addition to monthly averaging, some annuities offer daily averaging, which works the same as monthly averaging except that the closing value of the index for every day of underlying index is averaged together instead of just twelve month-end values.

RATCHET METHOD OR ANNUAL RESET

This method locks in the gain for that period, which is usually one policy year. Once the interest is credited to the policy, it becomes the value on which the next year's gain is calculated. And the index calculation for each policy year stands alone.

Advantage — 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 they have already earned. Therefore, their 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 them access to index-linked interest before the term ends.

Disadvantage — Their annuity's participation rate may change each year and generally will be lower than that of other indexing methods. Also, an annual reset design may use a cap or averaging to limit the total amount of interest they might earn each year.

- **Sets beginning index value for upcoming year at ending value for year just ended**
- **Locks in interest each year**
- **Increases odds of earning index linked interest**

SPREAD OR MARGIN METHOD

Companies that use this method calculate the increase in the S&P 500 for that policy year or term, and then subtract a percentage from that change. For example, if the gain in the S&P 500 for a policy year was 12% and the company used a spread of two percent (2%), then 10% would be credited to the policy for that year.

VESTING

Some annuities credit none of the index-linked interest or only part of it if one takes out all of their money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

HIGH WATER MARK INDEXING METHOD

The index linked interest, if any, is decided by looking at the index value at various points during the term, usually the annual anniversaries of the date of annuity purchase. The highest level of the index during the period is noted. The interest is then based on the difference between this highest index value (high water mark) and the index value at the start of the term. Interest based on the high water mark is added to the annuity at the end of the term (usually one to three years).

Advantage — 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.

Disadvantage — Interest is not credited until the end of the term. In some annuities, if they surrender their annuity before the end of the term, they may not get index-linked interest for that term. In other annuities, they 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 they might earn.

This approach is almost always used over multiple years with the high water period being annual. For example, assume a 10-year point-to-point interest term begins January 2nd with an index value of 1000. On January 2nd, five years later, the index value is 1100; however, the highest index value of the last five years was 1400. The indexed value percentage change is 40%.

The following chart provides an example of the high water mark indexing method, utilizing a one-year indexing term.

(For illustration, all index values are only expressed in whole numbers and calculation is not carried beyond three decimal positions.)

Date	Month	Index Value	
January 1	Begin	1,000	
February 1	1	1,014	
March 1	2	1,020	
April 1	3	1,033	
May 1	4	1,066	
June 1	5	1,019	
July 1	6	1,024	
August 1	7	1,033	
September 1	8	1,056	
October 1	9	**1,064**	**1,064**
November 1	10	1,038	
December 1	11	1,044	
January 1	12	1,061	

Table 5.2

Note: This example is for agent use only and is not to be used with consumers. This is only an illustration for understanding how annual point-to-point indexing works and is not a representation of past history or a prediction of the future movement of any index.

In the example above high water mark indexing would divide the ending index value (which is the high water mark occurring in month 9) by the beginning index value and then subtract 1 as follows:

Step 1: 1,064 ÷ 1,000 = 1.064

Step 2: 1.064 – 1 = .064 or 6.4%

In the example above the interest credited to the annuity for the just-ended index term would be 6.4 percent (6.4%) unless lowered by a participation rate, cap rate, or spread/margin/asset fee.

High water mark uses the highest value achieved by the index during the indexing period (usually 1 to 3 years) as the ending index value

LOW WATER MARK INDEXING METHOD

The index linked interest, if any, is decided by looking at the index value at various points during the term, usually the annual anniversaries of the date they bought the annuity. The low water mark is noted. The interest is based on the difference between the index value at the ending of the term and the lowest index value. Interest based on this calculation is added to their annuity at the end of the term. So the low water mark is used as the beginning value for the index calculation.

This approach is almost always used over multiple years with the high water period being annual. For example, assume a 10-year point-to-point interest term begins January 2nd with an index value of 1000. On January 2nd, five years later, the index value is 1100; however, the highest index value of the last five years was 1400. The indexed value percentage change is 40%.

Low water mark uses the lowest value achieved by the index during the indexing period as the beginning index value

POINT-TO-POINT INDEXING METHOD

Point-to-point is one of the methods commonly used to measure the change in a chosen index. This method compares the index level at two points in time, such as the beginning and ending dates of the time period. 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 the annuity at the end of the term. The term period may be for any number of years (i.e., one policy year or three, five, or seven policy years). For example, if starting index is 1000 and ending index is 1200, then the indexed value percentage change is 20%.

- **Advantage** — 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.
- **Disadvantage** — Since interest is not credited until the end of the term, typically six or seven years, they may not be able to get the index-linked interest until the end of the term.

Annual point-to-point indexing is the easiest indexing method for most people to understand. Point-to-point indexing can be used as monthly point-to-point, annual point-to-point, or long-term point-to-point.

Below is an example of the annual point-to point indexing method using the following assumptions:

- Policy year runs from January 1, of any given year to January 1, of the following year;
- Indexing term is one year.

(For illustration, all index values are only expressed in whole numbers and calculation is not carried beyond three decimal positions.)

Date	Month	Index Value
January 1	Begin	1,000
February 1	1	1,014
March 1	2	1,020
April 1	3	1,033
May 1	4	1,066
June 1	5	1,019
July 1	6	1,024
August 1	7	1,033
September 1	8	1,056
October 1	9	1,064
November 1	10	1,038
December 1	11	1,044
January 1	12	1,061

Table 5.3

Note: This example is for agent use only and is not to be used with consumers. This is only an illustration for understanding how annual point-to-point indexing works and is not a representation of past history or a prediction of the future movement of any index.

In the example above annual point-to-point indexing would divide the ending index value by the beginning index value and then subtract 1 as shown in the following chart.

Step 1: 1,061 ÷ 1,000 = 1.061

Step 2: 1.061 – 1 = .061 or 6.1%

In the example above the interest credited to the annuity for the index term just ended would be 6.1 percent (6.1%) unless lowered by a participation rate, cap rate, or spread/margin/asset fee.

Monthly point-to-point indexing measures the movement in the index value from the same day each month to the same day in the next month to determine the monthly movement in the index. If the monthly movement in the index is positive, it is used in the calculation, though there is usually a cap on how much monthly upward

movement can be used in the calculation (usually 2.5% to 3% per month maximum). If the monthly movement in the index is negative, it is used in the calculation and there is usually no limit on the amount of monthly downward movement in the index that can be used in the calculation. At the end of the policy year the insurer will add up the twelve monthly movements in the index value to determine the change in the index to be credited to the annuity.

Since the monthly-point-to-point indexing formula is already subject to a monthly cap on the upward movement, there is usually not a cap rate applied to the overall end result of the twelve months. However, a participation rate or spread/margin/asset fee may apply.

The following chart presents an example of monthly point-to-point indexing using the following assumptions:

- A monthly cap of 2.5% per month on the amount of upward index movement used in the calculation;
- No monthly cap on the amount of downward movement of the index used in the calculation;
- The first of each month is the measurement day;
- Indexing term is one year.

(For illustration, all index values are only expressed in whole numbers and calculation is not carried beyond three decimal positions.)

Date	Month	Index Value	Percent Change	Used in Calc	Cumulative
January 1	Begin	1,000	Begin		
February 1	1	1,014	1.40%	1.40%	1.40%
March 1	2	1,020	0.59%	0.59%	1.99%
April 1	3	1,033	1.27%	1.27%	3.26%
May 1	4	1,066	3.19%	2.50%	5.76%
June 1	5	1,019	(4.41%)	(4.41%)	1.35%
July 1	6	1,024	0.49%	0.49%	1.84%
August 1	7	1,033	0.88%	0.88%	2.72%
September 1	8	1,056	2.23%	2.23%	4.95%
October 1	9	1,064	0.78%	0.78%	5.73%
November 1	10	1,038	(2.44%)	(2.44%)	3.29%
December 1	11	1,044	0.59%	0.59%	3.88%
January 1	12	1,061	1.63%	1.63%	5.51%

Table 5.4

Note: This example is for agent use only and is not to be used with consumers. This is only an illustration for understanding how monthly point-to-point indexing works and is not a representation of past history or a prediction of the future movement of any index.

In the example above, the monthly point-to-point indexing calculation would result in interest crediting of 5.51% for the indexing year. The 5.51% represents the total of the monthly up or down movements in the index value as measured by the calculation. If a participation rate or spread/margin/asset fee were present in the calculation, this would reduce the amount credited to the annuity.

Note: In month four the index rose 3.19%, but only 2.5% was used in the calculation due to the monthly cap.

Long-term point-to-point indexing works like annual point-to-point indexing, except that the indexing period is longer than one policy year. Usually it is a two- or three-year indexing term; however, it can be even longer.

Binary (or **Triggered**) is a version of point-to-point where a specified interest percentage is credited only if the point-to-point index value percentage change is achieved (usually 0%).

For example, assume an interest term begins January 2nd with an index value of 1,000, the trigger point is zero percent (0%) increase and the specified interest rate is six percent (6%). The index value one year later is 1,100. Because the index value increased by greater than equal to zero percent, the indexed value percentage change is 6%.

SURRENDERS DURING THE TERM

If a partial surrender is made during the index term, no index credits will be granted on funds withdrawn, and any future potential index growth on such funds would be forfeit. Any partial surrenders would also reduce any payable death benefit.

During the index term, if the full minimum surrender value were taken out, the certificate would terminate at that point.

Typically, the annuity owner can withdraw up to 10% of the initial premium investment each year, after the first anniversary, without surrender charges. However, remember that the IRS may impose some taxes and penalties if the annuitant is under age 59½ at the time.

COMBINATION OF INDEXING METHODS

Many fixed indexed annuities allow the annuity owner to allocate funds among several different indexes and indexing methods within the same policy year. In this case the annuity owner could have three or more buckets of money using different indexes and different indexing methods.

INTEREST RATE CREDITING

The way in which companies credit interest varies. This can make a big difference in the amount of money one's policy will earn.

Some companies will only **add interest** to their annuity. For example, if they paid a $50,000 premium and during the first policy year they earned $5,000, the interest for the second policy year is calculated on $50,000—**NOT** $55,000. There is no compounding of interest that will lower the ultimate rate of return.

FLUCTUATION OF CAP AND PARTICIPATION RATES

Participation and cap rates are typically fluctuating parts in the interest crediting formulas used in fixed indexed annuities. Participation rates and cap rates can be

adjusted by the insurer (usually subject to minimums guaranteed for the life of the contract).

The reason these rates will fluctuate has to do with how the insurer invests the annuity premiums allocated to the indexing strategies. The majority of annuity premiums received is used to support the product's minimum guarantees. As with any fixed annuity, the funds used to back these guarantees are invested in bonds and other long-term instruments.

HEDGING INDEXING STRATEGIES

Once the minimum guarantees have been actuarially reserved, the remaining portion of the premiums can be used to cover expenses and purchase index options. These index options provide the ability for the insurer to credit gains in the index to annuity contracts.

Different companies use different strategies to perform their index hedging, but they all utilize index options in one way or another to provide index-linked interest to their annuity owners. The cost of these index options will vary during different economic environments, and most companies do not spend their entire options budget up front due to the fluctuation in the costs of index options. If the cost of index options increases significantly, the insurer can adjust the Cap Rate or Participation Rate on a prospective basis to sufficiently lower the future liability to the annuity owners to bring the option's cost within budget.

Most insurers purchase index options with a "strike date" (option life) one year or less in the future. This helps to understand why the cap rates and participation rates are usually guaranteed for a year at a time. Each year the insurer has to purchase index options to cover any index gains that may be credited during the ensuing year. If the cost of index options were to decrease, the insurer could afford to increase the participation and cap rates for the upcoming year.

Option costs fluctuate year to year based on market conditions, so if the price of options is higher in a given renewal year than what was assumed at the time the policy was issued, fewer options can be purchased. The end result in this scenario is that renewal caps on the policy will have to be lowered (fewer options purchased translates into a lower cap). Conversely, lower option costs result in higher renewal caps.

FACTORS AFFECTING INDEX OPTIONS PRICES

There are two main factors that drive the costs of index options—market volatility and guaranteed rates of return.

MARKET VOLATILITY

Since the performance of the equity markets do fluctuate—and the greater the "swing" in performance and the shorter the timeframe—the more volatile the equity markets are. Market volatility affects the likelihood that an option will pay off and is used to predict the standard deviation expected for the coming year in a specific stock index. This has a big impact on the pricing of index options.

Depending on the indexing method used within a particular annuity, a different type of index option will be purchased. The price of an index option purchased to hedge against a monthly point-to-point indexing method will react differently to increased market volatility than an index option purchased to hedge an annual point-to-point indexing method.

RISK FREE RATE OF RETURN

The most commonly used benchmark for risk-free rate of return is the rate of return on government-issued treasuries. An increase in the risk-free rate of return usually causes the price of options to increase, and a decrease in the risk free rate of return will usually cause a decrease in the price of options.

MID-TERM WITHDRAWALS

With most fixed indexed annuities, if a withdrawal is made during the index term, no index credits are granted on funds withdrawn. Because the amount of interest to be credited is calculated based upon the index movement during the index term (which has not yet occurred), the insurer doesn't know what amount of interest to credit to a withdrawal or surrender during the index term. If an insurer took the approach of determining the interest that would be credited if the calculation were performed on the withdrawal date (in effect shortening the index term), it might place them at risk of an annuity owner trying to time the withdrawal at a point when the interest would be the greatest.

The longer the index term, the greater the likelihood that any unplanned withdrawal made by the annuity owner will be mid-term. Liquidity is always a suitability issue when selling an annuity, and this is another good example indicating that the annuity

owner needs to have other funds within their financial household that can serve as an emergency fund.

Lack of interest being credited to a midterm withdrawal is a separate issue from the surrender charge.

MINIMUM NONFORFEITURE RATE VS. MINIMUM ANNUAL CREDITED RATE

In this section, we will compare the two. However, before the comparison, we present the NAIC Annuity Nonforfeiture Model Regulation, Section 3 Definitions for clearer understanding of the terminology used in this context.

DEFINITIONS USED IN THIS CONTEXT

Section 3. A. "**Basis**" carries two meanings.

(1) When used in the context of an initial or redetermination method, "basis" means the specified period over which an average is computed that produces the value of the five-year Constant Maturity Treasury (CMT) rate. The "specified period" could be as short as a single day. The same basis shall apply to all indexed benefits and the non-indexed benefit, if any.

(a) The basis may also use a specified period that is determined by the level of change in the CMT rate, or any other date dependent methodology adopted by the NAIC and approved by the commissioner. A specifically excluded method is one that defines the nonforfeiture rate as the lowest rate in a specified time period. A method based upon changes in CMT levels must move up or down in an identical manner with changes in interest rates, subject to statutory minimums and maximums.

(b) If the basis uses a specified period determined by the level of change in the CMT rate:

(i) The nonforfeiture rate applicable at the time this subsection is first utilized for a contract form shall be determined by a method using a specified period or another approved date dependent methodology.

(ii) A symmetrical range shall be defined that will determine when the rate shall be updated. The maximum allowable range shall be plus or minus fifty (50) basis points.

(iii) At the beginning of each modal period (e.g., monthly, quarterly, etc.), a potential nonforfeiture rate shall be calculated using the method in (i), without incorporating any caps or floors. The “modal period” is the period the company specifies during which the current nonforfeiture rate will remain fixed.

(iv) If the difference between the potential nonforfeiture rate and the current initial nonforfeiture rate is less than or equal to the range, the current nonforfeiture rate shall not be updated.

(v) If the difference between the potential nonforfeiture rate and the current nonforfeiture rate is more than the range, the current nonforfeiture rate shall be updated to be equal to the potential nonforfeiture rate adjusted for rounding and any caps or floors.

(2) When used in the context of equity-indexed benefits, “basis” means the point in time used for establishing the parameters incorporated into the calculation of the value of the indexed options. These parameters include the risk free rate, dividend yield, index volatility, prior index values if the option is path dependent, and any other relevant parameters.

(B) “**Indexed benefits**” means a benefit in an annuity contract in which the value of the benefit is determined using an interest crediting rate based on the performance on an equity-based index and contract parameters. Excluded from this definition are variable benefits of separate account variable annuities and indexed guaranteed separate account contracts purchased by institutional buyers.

C. “**Index term**” means each period of time until the next indexed interest crediting date.

D. “**Initial method**” means the basis upon which the initial nonforfeiture rate is established and the period for which it applies. The period may last for the entire duration of the contract.

E. “**Initial nonforfeiture rate**” means the nonforfeiture rate applicable at contract issue.

F. “**Minimum nonforfeiture amount**” means the minimum value required under the [insert applicable references to Section 4B of the Standard Nonforfeiture Law for Individual Deferred Annuities] of the [insert jurisdiction] Insurance Laws. It reflects net considerations, the nonforfeiture rate, and other items as specified in [insert applicable references to Section 4A of the Standard Nonforfeiture Law for Individual Deferred Annuities] of the [insert jurisdiction] Insurance Laws.

G. “**Nonforfeiture rate**” means the interest rate used in determining the minimum nonforfeiture amount. This will be determined at issue (initial nonforfeiture rate) and, if applicable, each subsequent redetermination period (redetermination nonforfeiture rate).

H. “**Redetermination method**” means the redetermination date, basis and period for all future redetermination nonforfeiture rates.

I. “**Redetermination nonforfeiture rate**” means the nonforfeiture rate applicable at redetermination.

THE MINIMUM NONFORFEITURE RATE

Annuity issuers are required to comply with the minimum nonforfeiture interest rate requirements in the state of issue. Most states require between one percent and three percent (1% and 3%) minimum nonforfeiture rates for the life of the annuity, with the amount to be guaranteed potentially fluctuating with the Five-year Constant Maturity Treasury rate less 125 basis points. If dealing with an indexed annuity that allows “substantive” participation in the performance of an index, up to 225 basis points can be deducted from the Five-year Constant Maturity Treasury rate. In addition, an insurer can re-determine the nonforfeiture amount as economic conditions change. This re-determination is not used often due to the administration and tracking required. The method for calculating the minimum nonforfeiture rate and amount does not have to be disclosed in the annuity contract in most states.

THE MINIMUM ANNUAL CREDITED RATE

The contractual guaranteed interest rate to the consumer must meet or exceed the statutorily required minimum nonforfeiture value. Unlike the minimum nonforfeiture rate and amount, the minimum guaranteed value must be clearly defined in the contract. In some annuities these rates and amounts are the same because the guaranteed value is going to equal the nonforfeiture value, but they can be different.

The annuity contract must define clearly what the guaranteed minimums are, and the company needs to demonstrate separately to the commissioner that the contractual guarantees listed in the contract meet or exceed the required minimum nonforfeiture value. A typical minimum credited annual rate for a fixed indexed annuity is 90% principal growing at 3%.

An interesting note is that the most states’ minimum nonforfeiture regulations require a separate bucket if a fixed indexed annuity has a fixed account in it. In this situation,

there is a nonforfeiture rate associated with the fixed account or the fixed option, and this rate would be the five-year Constant Maturity Treasury rate minus 125 basis points. There can also be a separate rate for the indexed money, which would be the five-year Constant Maturity Treasury rate minus 225 basis points.

FIXED INDEXED ANNUITIES

The fixed indexed annuity, in its simplest form, is an annuity product that provides some of the potential long-term growth of the chosen index. This means that the interest rate credited by the insurance company at the end of each index period (usually policy year) is based on the performance of the chosen index as measured by the indexing formula. As you know, the method by which the interest rate is calculated is the indexing method and may be subject to several fluctuating parts, such as a participation rate, cap rate, floor rate, or administrative/asset fee.

The fixed indexed annuity provides the downside guarantees of an annuity. This means that once the contract owner makes a premium payment, he or she will never have less value in the account than the sum of premium payments made. Once interest has been credited to the fixed indexed annuity, the value of the annuity will never decrease unless a withdrawal is made and/or a surrender charge applies—even if the chosen index decreases.

The interest rate is added to the account value if the underlying market index is positive. A fixed indexed annuity offers no-risk market exposure; therefore, there is no potential loss of account value. As the stock market moves in cycles, it is most important to have a balanced portfolio to help achieve the growth the consumer needs yet still protect against risk. While there is security in keeping a certain balance in the bank account, there's also another significant risk—outliving those savings.

So how can consumers protect their savings and accumulate more for the future? Fixed indexed annuities may fit the bill. This option delivers the safety of principal protection with higher growth potential in a low interest rate environment. Consider protected growth for a stronger retirement income plan with a fixed annuity because it offers fixed growth that outperforms traditional deposit accounts, protection from losses and tax advantages.

Today, investors are holding $13.4 trillion on the sidelines—up 5.5% year over year. In today's low interest rate environment, investors holding on to cash will fight an uphill battle getting to their retirement income goals.[18]

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[18] Federal Reserve, St. Louis Fed. Guide to the Markets – U.S. Data as of April 30, 2017

The average yield on money market accounts over the past five years is one percent (1%) or less. Explore possible alternatives to the lower returns of cash holdings with a solution that may also help protect the funds from market losses. Compare this to the average expected return of a fixed indexed annuity issued today—
3.7% to 4.7%![19]

Fixed indexed annuities can provide:

- **Fixed growth that outperforms traditional deposit accounts**
- **Protection from losses**
- **Tax advantages**

COMMON INDEXES USED IN FIXED INDEXED ANNUITIES

There are two most commonly used indices in fixed indexed annuities are the Standard & Poor's 500 Index and the Dow Jones Industrial Average (DJIA), with the S&P 500 being the most common.

The S&P 500 index was devised a number of years ago by the Standard & Poor's Company. Today the S&P 500 Index is widely regarded as the benchmark index by which U.S. stock market performance is measured.

The origins of the S&P 500 Index go back to 1923 when Standard & Poor's introduced a series of indices which included 233 companies and covered 26 industries. The Index as it is now known was introduced in 1957. Today, the S&P 500 encompasses 500 companies representing 90 specific industry groups.

The S&P 500 includes a representative sample of common stocks traded on the New York Stock Exchange, American Stock Exchange, and NASDAQ National Marketing System. It is one of the U.S. Commerce Department's leading indicators. In addition, it represents over 70% of the total domestic U.S. equity market capitalization.

The **Dow Jones Industrial Average** (DJIA) is the oldest index and probably the most well known gauge of stock market performance. The Dow (as it is common called) is composed of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The Dow includes companies such as the Walt Disney

[19] FDIC, https://www.fdic.gov/relations/resources/rates/previous.html

Company, Exxon Mobil Corporation, Chevron Corporation, Boeing, Nike, Apple, Inc., and many other high profile corporations.

The primary objective of the Standard & Poor's 500 Index is to be the performance benchmark for the U.S. stock market performance.

- The S&P Index is a market value-weighted index (shares outstanding times stock price) in which each company's influence in Index performance is directly proportional to its market value.
- The S&P 500 does not contain the 500 largest stocks. Although many of the stocks in the Index are among the largest, there are also some relatively small companies. However, they are generally leaders within their industry group.
- S&P identifies important industry groups within the U.S. economy and then allocates a representative sample of stocks within each group to the S&P 500. There are four major industry sectors within the Index: Industrials, Utilities, Financial, and Transportation.
- Since 1968 the Index has been a component of the U.S. Commerce Department's list of leading indicators that track key sectors of the U.S. economy.

S&P INDEX COMMITTEE

The S&P Index Committee is responsible for establishing index policy. The management of the S&P 500 Index is totally objective and independent from Standard & Poor's other business operations and interests. Maintaining stability of the composition of the S&P 500 Index is a primary consideration. Companies within the Index are generally removed because of mergers, acquisitions and bankruptcy filing. Companies are not removed from the Index because of anticipated good performance.

FIXED INDEXED ANNUITIES VS. TRADITIONAL FIXED ANNUITIES

An indexed annuity differs from other fixed annuities in the way it credits interest to an annuity's value. Most fixed annuities credit interest calculated at a rate stated in the contract. The rate that is credited is determined by the insurance company. Fixed indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how any additional interest is calculated and credited. How much additional interest a contract owner earns, and when it is credited, depends on the features of the particular annuity.

Many indexed annuities promise to pay a minimum interest rate. The rate that is credited to the annuity value is agreed to be no less than this minimum guaranteed rate—even if the index-linked interest rate is lower. The value of an indexed annuity will not drop below a guaranteed minimum amount.

For example, many single premium annuity contracts guarantee the minimum value will never be less than 90% (100% in some contracts) of the premium paid, plus at least three percent (3%) in annual interest (less any partial withdrawals). The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

UTILIZING THE FIXED INDEXED ANNUITY

Let's see how a fixed indexed annuity can suit Michelle's needs, as she is still about ten years away from retirement.

Example:

She wants to protect the savings she's worked hard to build, so she moved investments into a money market account. She's also worried she won't have enough to live comfortably in retirement.

Michelle's advisor recommends taking $100,000 from her portfolio to purchase a fixed indexed annuity. He shows her how the annuity stacks up against her current plan after just one year.

	Money Market Account at 0.87%	Fixed Account at 2.50%
Amount invested	$100,000	$100,000
Interest after 1 year	$870	$2,500 Fixed Account
Interest after annual taxes are assessed (32% tax rate)	$592	$2,500 Fixed Account
Potential annual return	0.59% (after taxes)	2.50% (tax-deferred)
		324% more

Table 5.5

VARIABLE INDEXED ANNUITIES

Variable indexed annuities provide the opportunity to earn returns based, in part, on the positive change of an external index.

TERMINOLOGY USED IN VARIABLE INDEXED ANNUITIES

Investment amount — Also called principal, this is the amount of the initial investment and any additional contributions. Account performance simulates market index performance.

Indexed account — Tracks a specific portion of the market. While you are not invested directly in an index, your indexed account performance simulates the performance of the market index (subject to performance cap and level of protection selected).

Level of protection — The percentage loss that will be absorbed from a market downturn in the indexed accounts (10%, 20%, 30% or 100% options available). If a market drop is in excess of the protection level, there is a risk of loss of principal.

UTILIZING THE VARIABLE INDEXED ANNUITY

Let's meet James and see how a variable indexed annuity can fit his needs. James is nearing retirement and though protection is his highest priority, he still wants opportunities for growth.

When it comes to investing, James' highest priority is protecting his investments. But he knows he needs to continue growing his money. James is a moderately conservative investor who wants a plan that will manage his money wisely and efficiently.

An indexed variable annuity could be a good fit for James because it helps him keep his income and investment goals on track. He can allocate into an indexed account so he will have confidence in his level of protection during market downturns without giving up the opportunity for growth.

Let's look at a quick example—A balance of protection and growth potential in action.

Example:

Let's say James invested $100,000 into a one-year indexed account with a 10% level of protection. During the first term, the index dropped 12%, leaving an ending value of $88,000. Since James selected the 10% level of protection, his account only experienced a 2% loss, leaving him with $98,000 at the end of term one.

James decides to reinvest into another one-year indexed account with the same 10% level of protection. During the second term, the index goes up by 8%, bringing the total value to $95,040. Since James was protected from 10% of market loss during the first term his ending account value after term two was $103,880. In this example, James ends up with $8,840 more than the index with the indexed variable annuity.

James can continue to reinvest into different indexed accounts and adjust his strategy if needed.

Note: *Examples are hypothetical and for illustrative purposes only. They do not reflect a specific indexed account. This example assumes the hypothetical performance cap for term one is 6% and the protection level selected is 10%. A new cap is declared for each additional term. This hypothetical example is assuming the same cap and protection level for*

term two. The value will grow up to the cap at a rate based on the market index chosen. Indexed accounts are tied to market performance, but they are not an actual investment in the stock market.

FINDING THE BALANCE

Most investors want the best opportunities for their savings, but it often becomes a balancing act between a sense of security and the growth potential of the markets. An indexed variable annuity can provide some of the features and benefits of both worlds. How does it compare with your other investments?

There are numerous things investors like about fixed annuity investments including safety, liquidity, and predictable growth.

Conversely, low rates, limited growth, and inflation risk are often negatively associated with these investments.

On the other hand, many investors value variable annuity investments because of their growth potential, protection against inflation, and death benefit features.

Subsequently, cost and complexity are common negative connotations surrounding variable annuities.

INDEXED ANNUITIES VS. VARIABLE ANNUITIES

Variable annuities invest money in subaccounts. Indexed annuities provide a percentage of the returns of a particular index. The company then credits the annuity account with the gain or a guaranteed minimum percentage.

INVESTMENT FLEXIBILITY

In an indexed annuity, the contract owner can only participate in the returns generated by the chosen index; or receive a guaranteed minimum interest return if that index doesn’t perform as well as anticipated.

In a variable annuity, the contract owner can switch the way in which the funds are invested. The contract owner can opt to put money into several different types of funds such as large cap stocks, foreign stocks, bonds and money market instruments.

Participation Level

In an indexed annuity, the account will only reflect the chosen participation level. The higher the guaranteed return selected, the lower the participation level.

In a variable annuity, the contract owner receives the full return generated by the underlying investments.

The Cap

Indexed annuities typically have a cap on the amount of return on investment. The cap also affects the percentage of the guaranteed return. Variable annuities have no cap on the amount to be earned.

Interest Guarantees

The indexed annuity carries guaranteed minimum interest that applies to living benefits and death benefits.

With a variable annuity, there are no guarantees on the return, unless covered by a rider, which of course costs.

Management

With an indexed annuity, there is no selection or stocks or management involved; it simply follows the movement of a particular index.

Funds invested in a variable annuity must be managed, and those managers must be paid for their services; at the consumer's expense.

Asset Allocation

Variable annuities offer automatic asset allocation. The contract owner selects the percentages of each investment chosen, according to various levels of investment risk. To maintain a balance in a fluctuating market, funds are reinvested as appropriate to achieve profit rather than loss.

The indexed annuity only uses one index so there's no possibility for asset allocation.

INDEXED ANNUITIES VS. SIMILAR INVESTMENT VEHICLES

There are several alternative options available today, including fixed annuities, variable annuities, certificates of deposit, money market, bonds/Treasuries, stock market, S&P 500, 401(k)'s and individual retirement accounts (IRA's). A diversified portfolio is balanced.

INDEXED ANNUITIES VS. FIXED ANNUITIES

Fixed annuities are interest-based contracts issued and backed by an insurance company that locks in an annual rate of return for a single lump sum payment. Future rates are predetermined and typically range from three percent to eight percent (3% to 8%) depending on the length of term. Remember, a 10% tax penalty is levied against income withdrawals before the age of 59½.

The most desirable feature of fixed annuities is the guaranteed premium, which is also present in indexed annuities.

Where the two differ, and the fixed annuity pulls ahead, is the predictability of the annual return. With an indexed annuity, although the premium is guaranteed against loss, there's no way to know what the account balance will be in the following year—it might grow or it might lose. If the consumer doesn't want the deviations in growth rate, the fixed annuity would be a more appropriate choice. However, the indexed variable rate may yield higher returns in the long run.

INDEXED ANNUITIES VS. VARIABLE ANNUITIES

A variable annuity is a stock market portfolio contract managed by a broker for an insurance company. Subaccounts of various risk levels are chosen by the contract owner and pay out interest depending on performance. Typical annuity terms and features apply: tax deferred growth, potential withdrawal charges, and the 10% tax penalty for premature withdrawals (prior to age 59½).

Variable annuities offer a slight advantage over indexed annuities on account of their potentially higher yields, but for a retirement savings plan indexed annuities arguably outweigh them with guarantees against losses. Consumers who have investment experience and have the time to study the markets and make appropriate adjustments to their investment portfolio, a variable annuity may be a good choice. Otherwise, the comfort and management ease of an indexed annuity may be more appropriate.

INDEXED ANNUITIES VS. CERTIFICATES OF DEPOSIT

Certificates of deposits provide a fixed interest rate for a specified period of time (usually one to five years). The financial institution that issued the certificate takes that initial upfront payment and reinvests it in higher-yield debit instruments such as government bonds. At the end of the term, the funds that were originally used to purchase the certificate PLUS interest is returned to the certificate owner in one lump sum. Interest rates typically range from two percent to five percent (2% to 5%), depending primarily on federal rates.

Certificates of deposit are safe, guaranteed, offer moderate growth with marginal liquidity, and are easy to set up; they're taxed at ordinary rates and feature no tax deferral benefits. Similar in many respects to fixed annuities, certificates of deposit are a good option for investors who are looking for pre-retirement income so the 10% early withdrawal penalty is avoided.

Certificates of deposit and indexed annuities are totally different products for different types of investors. Certificates serve the purpose of sheltering a retirement plan from loss and counteracting inflation. Indexed annuities are more aggressive instruments designed to actually grow savings. Both vehicles have a place in a diversified portfolio retirement plan.

INDEXED ANNUITIES VS. MONEY MARKET FUND

A money market is a high interest savings account managed by a financial institution. A money market fund (also called a **money market fund**, or a **fixed income fund**) is an open-ended fund that invests in short-term debt securities such as U.S. Treasury bills and commercial paper. Money market funds are managed with the goal of maintaining a highly stable asset value through liquid investments, while paying income to investors in the form of dividends.

All money market funds comply with industry-standard regulatory requirements regarding the quality maturity, liquidity, and diversification of the fund’s investments. Money markets are secure, FDIC (Federal Deposit Insurance Corporation) insured, completely liquid, and offer interest rates in the range of two percent to four percent (2% to 4%), which is substantially higher than ordinary bank savings accounts. Money markets offer lower interest rates than certificates or annuities, and interest rates change on a day-to-day basis, depending on federal rates.

Money market accounts have moderate minimum balance requirements ($1000+) and may limit withdrawals to several times a month. Even so, they are considered

completely liquid, with no withdrawal limits or penalty fees. Money market accounts allow further investments to be made throughout their lifetime and never expire.

A money market account is hardly an alternative to index annuities. As a certificate of deposit, a money market has its place alongside more aggressive instruments, helping curtail annual inflation on funds that might be needed tomorrow.

Indexed Annuities vs. Bonds/Treasuries

Bonds and treasuries are government or corporate loan contracts, including things like high-quality mortgages and federal promissory notes. Bonds backed by stable institutions like the U.S. government are very secure but offer low interest rates; typically two percent to four percent (2% to 4%) like mutual funds. Treasuries have low liquidity but can be purchased for short-or long-term investing.

Bonds are not high-yield, but they are solid retirement savings instruments. As alternatives, they closely emulate certificates of deposit and fixed annuities. As retirement approaches, it may be preferable to transfer more and more of the assets into bonds.

Indexed Annuities vs. Stock Market

Stocks offer the highest growth potential of any investment; however, they carry a propensity to lose investors money. Over the very long-term, stocks outperform all other investments. The stock market is great for discretionary investment, and much less suitable for storing retirement funds. And although a lot of risk can be hedged with a balanced portfolio and tempered investment strategy, the market often behaves irrationally. Over the long-term stocks may look more appealing, but the risk of losing all your money when you need it most, at retirement, is high.

Indexed Annuities vs. S&P 500

Historically, the S&P 500 averages a 10% to 12% annual return. Rather than purchasing a particular stock, investors can purchase an equity-traded fund that tracks the S&P 500 or another index. Similarly, the S&P 500 can be invested into through mutual fund and 401(k) or IRA subaccounts.

Which Indexed Annuity is Best?

As with any other insurance product, one must carefully consider their own personal situation and how they feel about the choices available. No single annuity design

may have all the features they want. It is important to understand the features and trade-offs available so they can choose the annuity that is right for them.

Keep in mind that it may be misleading to compare one annuity to another unless one compares all the other features of each annuity. They must decide for themselves what combination of features makes the most sense for them.

Also, remember that it is not possible to predict the future market behavior of an index.

QUESTIONS THE CONSUMER MUST ASK AND THE AGENT MUST ANSWER

- Am I interested in a variable annuity with the potential for higher earnings that are not guaranteed and willing to risk losing the principal? OR
- Is a guaranteed interest rate more important to me, with little or no risk of losing the principal? OR
- Am I somewhere in between these two extremes and willing to take some risks?
- How long is the term?
- What is the guaranteed minimum interest rate?
- What is the participation rate? For how long is the participation rate guaranteed?
- Is there a minimum participation rate?
- Does my contract have an interest rate cap? What is it?
- Does my contract have an interest rate floor? What is it?
- Is interest rate averaging used? How does it work?
- Is interest compounded during a term?
- Is there a margin, spread, or administrative fee? Is that in addition to or instead of a participation rate?
- What indexing method is used in my contract?
- What are the surrender charges or penalties if I want to end my contract early and take out all of my money?

- Can I get a partial withdrawal without paying charges or losing interest? Does my contract have vesting? If so, what is the rate of vesting?

KEY POINTS TO PONDER

- An annuity owner can typically withdraw 10% of the annuity value each year without incurring surrender charges.
- Market volatility and guaranteed rate of return are the two main factors that drive the costs of index options.
- The two most common indexing methods used in annuities are the S&P 500 and the Dow Jones Average.
- A deferred income annuity provides guaranteed lifetime income benefit, account value, and annual income.
- The participation rate determines how much of the gain in the index will be credited to the annuity.
- The cap rate is the maximum rate of interest an annuity will earn, regardless of the performance of the index.
- The floor rate is the minimum rate of return and is usually guaranteed to never fall below zero.
- With the high water mark indexing method, the interest is based on the difference between the highest index value and the index value at the start of term.
- With the low water mark indexing method, the interest is based on the difference between the lowest index value index value and the index value at the end of the term.

CHAPTER 5 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. Which of the following is NOT a feature that a deferred income annuity generally provides?

   a) Guaranteed lifetime income benefit
   b) Guaranteed lifetime income account value
   c) Guaranteed lifetime annual income
   d) Guaranteed tax-free payout

2. If the deferred income annuity contract value exceeds the value of the guaranteed lifetime income account, a 10% step up benefit will provide how much additional guaranteed income for life?

   a) 1%
   b) 10%
   c) 100%
   d) 102%

3. Typically, how much can an annuity owner withdraw from an indexed-linked annuity each year without incurring surrender charges?

   a) 1%
   b) 5%
   c) 10%
   d) 50%

CHAPTER 6

ADDITIONAL TYPES OF ANNUITIES

In this chapter we will discuss all the different types of annuities out in the market today. We will present the basics, as well as the benefits and risks of each.

THE HYBRID ANNUITY

This part-fixed, part-variable annuity is known as a **hybrid annuity**. The hybrid annuity, an industry-coined name, combines features of the variable annuity with features of the fixed annuity. Technically, there is no official hybrid category of insurance products. It is merely a marketing term that was coined by the insurance industry in response to the success of the "hybrid" car movement.

The hybrid annuity is a type of contract that allows investors to allocate funds to fixed rate and variable annuity components as part of the same investment vehicle. Most hybrid annuities allow investors to choose how they want to allocate assets.

The hybrid annuity allows investors to invest in an annuity that provides diversification among several different subaccounts. Hybrid annuities are a flexible tool that can be used for a broad range of unique income situations, including the following.

- **Multigenerational income**: For anyone who wants to set up an income stream that will pay out over two or more generations.
- **Income before age 59½**: If under age 59½ and want to take income from the retirement assets—but concerned about the tax penalty on early retirement income withdrawals.
- **Income for someone who isn't a spouse**: Perhaps for a sibling, a friend, a domestic partner or a business partner as beneficiary of the annuity.
- **1035 exchange by beneficiary**: An inherited nonqualified annuity that can be exchanged for one with different features, benefits, investment options or more flexibility.
- **Trusts**: Can be owned in a trust in order to offer tax-advantaged income and wealth transfer strategies.

- **Lifetime gifting**: May provide a tax-efficient way to gift nonqualified assets.

Each hybrid product will have different options available—of course, at an additional charge.

DESIGNING THE HYBRID TO SUIT THE CONSUMER'S NEEDS

Start as systematic withdrawal — An income hybrid starts with the idea that a systematic withdrawal gives the client the advantage of access and control of their principal investment. The income hybrid creates a withdrawal that is calculated in the same manner as traditional annuitization.

ADD lifetime income guarantee — However, instead of the insurance company taking control of the principal investment account, the client retains this control; and withdrawals come from this account. Because income is calculated in the same manner as traditional annuitization, the insurance company is able to add a lifetime guarantee similar to the lifetime guarantee offered by traditional annuitization.

ADD minimum payment guarantee (GIB) — In addition, for an extra fee, the insurance company can guarantee a minimum amount of lifetime payments through the guaranteed income benefit (or GIB).

ADD annuitization tax benefits — Finally, because the cash flow is identical to traditional annuitization, the IRS has ruled that the cash payments are taxed under the same rules as traditional annuitization.

Let's dive into the benefits of having the hybrid annuity's income stream be treated as though it were an annuitized policy.

When variable annuitization payments are made from the hybrid annuity contract, each payment includes a portion of the original investment (after-tax dollars) together with a portion of the gains in the contract—providing some nontaxable income with each payment creating a tax efficient income stream. The contract owner also retains access to the account value even after income payments begin.

However, that safety factor may just cost too much for some. For instance, with most fixed annuities, the investor is locked into a typical five-year time period before surrender charges are waived. With the hybrid, the owner may be locked in for around ten years. (Of course, surrender periods vary but, on the whole, the hybrid contains a longer surrender period than the fixed annuity.)

Hybrid annuities also have caps. Within the underlying investments, funds can rise or fall. For example, if the invested funds go up by 20% in any given year, but the hybrid has a cap of three percent (3%), the owner will only make three percent (3%) for that year.

Though there is no absolute definition of who should purchase a hybrid annuity, they may be a good choice for those who anticipate a longer need for income, while at the same time participating in both the bond and stock markets for additional growth potential. They are generally well-suited for investors who are seeking a combination of growth and income.

ADVANTAGES AND DISADVANTAGES OF HYBRID ANNUITIES

Hybrid annuities can offer additional benefits to the consumer in addition to the standard features found in other types of annuities. Their dual nature can provide guaranteed increasing income because the growth portion provides them with a hedge against inflation. Contracts that combine a fixed and variable annuity can also provide consumers with a lower level of downside risk than a variable annuity by itself, because the fixed portion will continue to pay out regardless of the performance of the variable subaccounts.

However, this dual nature makes these products especially complicated, and many consumers are not capable of understanding all of their technical features or limitations. Many hybrid products also come with extremely high fees, back-end surrender charge schedules, and inordinately high commissions. The guarantees and optional benefits offered by the hybrid may actually affect policy values.

ADVANTAGES AND DISADVANTAGES OF HYBRID FIXED INDEXED ANNUITIES

What are some of the advantages of a hybrid fixed indexed annuity?

- Provides growth of an income base, which accounts for future income;
- Provides the ability to have increasing income as a fledge against inflation;
- Has the upside market potential using popular indices;
- No actual market investment and no downside market risk;
- Provides pension styled income that cannot be outlived;
- Provides majority control of initial premium for unexpected expenses;
- Provides the ability for heirs to receive the full account value of what has not been withdrawn.

What are some of the disadvantages of a hybrid fixed indexed annuity?

- Are complex with moving parts that a can substantially limit growth potential;
- Income for life is lower than most immediate annuities without years of deferral;
- Growth guarantee is not a cash value and cannot be taken out in a lump sum;
- Most do not have any increasing income probability after the income rider is activated;
- Fees are charged for income riders costing typically about one percent (1%) annually for as long as the annuity is in effect;
- Surrender charges amount to around 10% for excessive withdrawals in early years;
- Heirs may pay ordinary income tax rates depending on how the hybrid is structured.

ADVANTAGES AND DISADVANTAGES OF HYBRID IMMEDIATE ANNUITIES

What are some of the advantages of a hybrid immediate annuity?

- Easier to understand;
- Provides the ability to have increasing income as a hedge against inflation;
- No market investment and no downside market risk;
- The largest pension styled income that cannot be outlived;
- Majority control of initial premium for unexpected expenses after a designated period;
- The ability for heirs to receive the full account value of what has not been withdrawn.

What are some of the disadvantages of a hybrid immediate annuity?

- No deferral period – income typically starts within 30 days;
- Surrender charges amount to around 10% for withdrawals in early years;
- Heirs may pay ordinary income tax rates depending on how the hybrid annuity is structured.

KEY QUESTIONS WHEN CONSIDERING A HYBRID ANNUITY

- Is the principal guaranteed?
- Does the annuity guarantee lifetime income?
- Will the annuity also cover a spouse if wanted?
- How is the income from a hybrid annuity taxed?
- Will the money that is left over go to beneficiary (or beneficiaries)?[20]

CD-TYPE ANNUITIES

This category contains those annuity products where the number of years that the interest rate is guaranteed is equal to the number of years the surrender charge exists. For example, annuity products that have a five-year guaranteed interest rate and a five-year surrender charge are examples of CD-type annuities.

In the following example, a single premium annuity offers an interest rate of 5.5%, which is guaranteed for five years, and the duration of the surrender charge is also five years.

INTEREST RATE 5.5% – GUARANTEED FOR 5 YEARS					
Years	**1**	**2**	**3**	**4**	**5**
Percentage Surrender Charge	**5.0%**	**4.0%**	**3.0%**	**2.0%**	**1.0%**

Table 6.1

CD-TYPE ANNUITY WITHDRAWAL CHARGES

Like most annuities, bonus and CD-type annuities allow an annuity owner to withdraw interest from their annuity without penalty. Some annuities allow contract owners to withdraw interest without paying a penalty at the end of the policy year.

Almost all annuities allow annuity owners to withdraw up to 10% of their account value before a surrender charge or withdrawal charge is applied. They must know

[20] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

how these charges apply before they buy an annuity policy to save themselves unnecessary expenses.

Most annuities offer a guaranteed interest rate for a period of time that is less than the number of years that the surrender charge applies. After the guaranteed interest period expires, the insurance company then declares the new interest rate for that policy year. When a person buys an annuity, they must be aware that the renewal rate will usually be lower than the initial guaranteed interest rate.

STRAIGHT LIFE ANNUITIES

Straight Life Annuity: "A fixed or variable annuity that pays a certain monthly or (rarely) annual sum for life of the annuitant and carries no death benefit. Generally speaking, an annuitant buys a straight life annuity and makes installment payments for it throughout his/her working life. Following retirement, the annuitant begins to receive the benefit, the amount of which may or may not be fixed in the annuity contract. A straight life annuity is designed to provide a stable income for the annuitant in retirement. Most straight life annuities make larger payments than other annuities because there is no death benefit."[21]

Straight life annuities, sometimes referred to as a "single life policy," are the least complex and least expensive of all the annuities, as there's less risk on the insurer for the policyholder to outlive the amount that they paid into the investment. Generally speaking, men collect slightly higher single life payouts due to shorter life expectancies than women.

Like all annuities, straight life annuities act as longevity insurance. Once the annuitization phase begins, this annuity pays a set amount per period until the annuitant dies.

Straight life annuities are a good choice for those who have no need to continue payments beyond death, such as payout to surviving beneficiaries. Straight life annuities may not be the best choice for couples who live off of the retirement income the annuity provides. Accordingly, such an annuity is best suited to individuals who lack a spouse or partner.

A straight life annuity provides benefit payments for the lifetime of the annuitant. It continues to pay as long as the annuitant is alive, even if the accumulated value of the annuity has been depleted. However, once the annuitant dies, the benefit

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[21] The Free Dictionary by Farlex, https://financial-dictionary.thefreedictionary.com/Straight+Life+Annuity

payments end, even if all of the money in the annuity account has not been paid out. This payout option is sometimes selected by those who need a maximum amount of income and have no dependents.

HOW A STRAIGHT LIFE ANNUITY WORKS

While many types of annuities allow the annuity owner to name a beneficiary (usually a spouse) who will be eligible for either continued payments or death benefits, a straight life annuity forgoes this added benefit in favor of higher guaranteed payments while the annuitant is alive.

With the omission of the survivor and death benefits, a straight life annuity owner can achieve the highest possible monthly payment. In effect, it acts as a straight bet on longevity; the longer the owner/annuitant lives, the more they will receive in payments. It has no provision for limiting risk in case of premature death, in which case the insurance company keeps the balance.

A straight life annuity policy may be bought over the course of the annuitant's working life by making periodic payments into the annuity, or it could be purchased with a single lump sum payment. Usually, lump sum purchases are made at, or shortly after, the annuitant's retirement. Either payment option will result in the same regular payments and can be modified with optional riders, such as a cash-refund rider that pays out the remaining funds in the policy to a beneficiary.

REASONS TO PURCHASE A STRAIGHT LIFE ANNUITY

There are a number of scenarios where a straight life annuity can be beneficial for the consumer.

- Straight life annuities provide regular funds in retirement when the consumer is no longer working. This helps maintain a quality of life guarantee and predictability that variable investment options may not be able to do.
- Like all annuities, straight life annuities act as longevity insurance, where the income is guaranteed even if the annuity owner outlives the amount initially paid into the annuity.
- Considering that straight life annuities are geared toward single individuals, they are not the best choice for couples who are planning to live off of income derived from the annuity.
- Single male retirees can get the largest monthly payouts, due to the shortened life expectancies when compared to women.

- The premiums for straight life annuities can be funded in multiple ways, including:
    - Accumulated savings (cash);
    - The sale of mutual funds or stocks;
    - Transferring funds from a qualified retirement plan (i.e., IRA or 401(k));
    - Cashing in the surrender value of a life insurance policy through a 1035 Exchange, with reduced tax liability; and
    - Large settlements or windfalls.

When a person is the recipient of a large settlement or financial windfall, such as winning the lottery, they may run the risk of going on a shopping spree. By placing those funds in a straight life annuity, the money is preserved for later in life when it is generally needed more. This also has the added benefit of lessening any tax liability. Straight life annuities are all about security and consistency.

ADVANTAGES AND DISADVANTAGES OF THE STRAIGHT LIFE ANNUITY

What are some of the advantages of a straight life annuity? Straight life annuities are secure and easy. The policyowner has no investment decisions to make. Hand over the check, and let the insurance company handle the details.

What are some of the disadvantages of a straight life annuity? The most predominant drawback to a straight life annuity is dying too soon. If death occurs before all of the payments have been made, the insurance company will reap the rewards. The longer the policyowner's life, the more money the policyowner will get. The shorter the policyowner's life, the more money the insurance company will get. Also, the income and interest rates in the straight life annuity are fixed so the policyowner is locked in to those rates.

STRAIGHT LIFE ANNUITY TAX TREATMENT

The tax consequences of the straight life annuity depend on the original method of funding. If the funds come from a 401(k) or traditional IRA (with before-tax money), the annuity income will be taxed as ordinary income. If the funds come from a savings account or qualified Roth IRA withdrawal (with after-tax money), only the interest earned will be taxable.

GUARANTEED TERM LIFE ANNUITIES

This type of annuity contains the same components as the straight life annuity, with the exception that the annuitant is allowed to designate a beneficiary. If the annuitant dies before the specified term, the beneficiary will receive the remaining funds in a lump sum payment. The major disadvantage of this annuity is that once the term ends, there is no more annuity income to be had.

Example:

For instance, a 68 year-old male could receive a monthly income payable to himself as long as he is alive, or to his beneficiary should he die within the first 10 years. This option is known as "**Life Annuity with Payments for a Guaranteed Period**," and in this case the guaranteed period is ten years.

When issued, contracts include a payout table stating the minimum payout guaranteed by the company based on age and sex (according to state law). When the contract is annuitized, the payout will be based on the higher of two values: The guaranteed amount stated in the table, or the current value used at that time.

In this example, according to the payout table, for every $1,000 that is annuitized under the "**Life Annuity with Payments Guaranteed for 10 Years**" option, the monthly payout would be $5.68. This amount was guaranteed at the time the contract was issued, however the current payout rate which the company is using is $7.93. All payout rates are expressed as dollars per period (monthly, quarterly, semi-annually, annually) per $1,000.

Therefore, if this individual elected to annuitize $30,000 under this option, his monthly payout would be $237.90 per month. This dollar amount is guaranteed to be paid to him for as long as he lives. Should death occur in the first ten years, his beneficiary would receive the difference between 10 years of monthly income and the amount he actually received.

TWO-TIERED ANNUITIES

A two-tiered annuity is a product with three different values. These values are the tier-one value, the surrender value, and the tier-two value.

1. The first value is the **tier-one value**, which is the premium accumulated with interest earnings, just like a regular fixed annuity. This value is available to the client if they decide to surrender their contract as a lump sum after the surrender charge period.

2. The second value is the **surrender value**, which is the tier-one value less the surrender charge. This value is available to the client if they decide to surrender their contract as a lump sum during the surrender charge period.
3. The third value is the **tier-two value**, which provides a benefit typically higher than the tier-one value and is only available to the client if they annuitize the contract. Tier-two benefits could include higher interest rates, higher index crediting, bonuses or other benefits that encourage the client to annuitize, thereby leaving assets longer with the insurance company. In some products, clients must wait a certain period of time before they can access these higher tier-two values.

What are some of the advantages of two-tier products? Two-tier products can be valuable for the right consumer in several ways. If the consumer has a need for a lifetime stream of income, they could receive higher lifetime benefits under a two-tier product than under either a regular deferred annuity that is annuitized or an immediate annuity. Secondly, due to the design and pricing of two-tier products, tier-one credited rates could be higher than a non-tiered deferred annuity in the form of better participation rates, caps or fees.

What are some of the disadvantages of two-tier products? These products may not be suitable for clients that have short-term liquidity needs or a desire to pass on lump-sum benefits to their heirs. In addition, consumers usually have to wait a period of time to receive the higher tier-two values, and annuitization is required to receive those values, which spreads the benefits over a period of time.

Insurance agents should be very clear that the consumers they serve who are considering a two-tiered annuity understand the different values, how to access their values, and the restrictions or consequences of doing so. As always, consumers should assess their needs and examine all aspects of an annuity product before determining if that particular annuity design fits their needs and financial goals.

Due to their liquidity restrictions, two-tier annuities work best when used as a long-term retirement plan option rather than a cash investment. They are designed for people who have adequate savings and income to live on only the installment payments. If the policyowner would have to cash out their original investment to cover an emergency, a two-tier annuity is probably not a good investment choice for because of the strict withdrawal penalties.

Note: Many states have declared two-tier annuities illegal due to unscrupulous marketing practices that could be involved in their sales.

BOND INDEXED ANNUITIES

Like indexed annuities, bond indexed annuities credit interest based on the performance of a third party index. In this case, it is a prescribed group of bonds that have been identified to reflect the performance of selected risk\reward groups of bonds combined to form a pool on which a bond index can be calculated over a period of time. This bond index is then applied to determine the actual interest that will be credited to the accumulated funds in the annuity.

There are an increasing number companies that are combining different types of annuities within a single product. It now possible to buy one annuity product that offers people the choice of placing all or part of their funds in a CD-type, index, fixed or bond strategy account.

The following is a list of such products and the accounts that are available within those products. The last three bond references are key to this discussion of bond indexed annuities. They give examples of various types of bond indexed groupings that underlie the bond indexed annuity and upon which their index will determine the interest to be credited to the annuity.

Fixed Account — Traditional fixed annuities such as those listed in fixed annuity category.

CD-type Account — Annuities where the guaranteed period is equal to the surrender charge period. Those products are listed in the CD Type Annuities Category.

Index Accounts — Products that offer interest crediting methods based on the performance of one of the major indices such as the S&P 500 Index. These types of products are listed in the Index category.

Convertible Bond Account — A portfolio of bonds designed for those who want to take advantage of the stability of the bond market and have the potential for stock-like returns.

Investment Grade Account — A portfolio of bonds designed for those who want returns based on the long-term stability of the bond market. This portfolio is designed to produce rates of return similar to the Lehman Brothers Government/Corporate Bond Index.

High Yield Bond Account — A portfolio of bonds designed for those who want rates of returns based on bonds rated BBB or less by Standard & Poor's. A high yield bond

offers a higher yield that corresponds to a higher level of risk than investment grade bonds. The Lehman Brothers High Yield Bond Index tracks the performance of high yield bonds.

Bond indexed annuities provide another choice of performance-backed annuities that have varied methods of growth potential to best adapt to a person's needs for diversification and accumulation for the future, given varying market and interest rate environments.

MARKET VALUE ADJUSTED ANNUITIES

Some fixed annuities impose a **market value adjustment** (MVA) on surrenders and withdrawals prior to the end of the index period. MVAs adjust the amount surrendered or withdrawn to reflect the effect of current economic conditions on the value of the insurance company's invested assets (generally bonds) supporting the guaranteed crediting rate of fixed indexed annuities. Under some fixed indexed annuities, the MVA adjustment can be "positive," in which case, the withdrawal or surrender proceeds will be reduced, or "negative," and these proceeds will be increased to reflect asset gains. In every case, however, an MVA adjustment will not be allowed to reduce product values below the minimum guaranteed values required by state insurance law. This maintains the insurance status of the product by limiting the degree of investment risk that the insurance company transfers to the owner.

Market Value Adjustments on annuities and life policies have been around for over a decade, but MVAs on annuities have become particularly popular since early 1994, when the federal government began decreasing rates at a rapid pace.

An MVA can be attached to a deferred annuity that features fixed interest rate guarantees combined with an interest rate adjustment factor that can cause the actual crediting rates to increase or decrease in response to market conditions.

HOW THE MARKET VALUE ADJUSTED ANNUITY WORKS

- The owner places money in an account that earns a fixed rate of interest (the annuity values are supported by the full faith and credit of the insurance company).
- The insurer holds the owner's money in this account for the length of the designated guarantee period. At the end of the guarantee period there is usually a "window" when no withdrawal charges or market value adjustment will apply.

- At the end of the guarantee period, the company declares a new current interest rate, or renewal rate, which may be higher or lower than the previous rate, but not below the minimum interest rate guaranteed by the policy (typically three percent or four percent) (3% or 4%).

HOW THE MARKET VALUE ADJUSTED ANNUITY IS DIFFERENT

If one wants to surrender their annuity prior to the end of the guarantee period, an "adjustment" will be made. The actual contract value they receive has the potential to be positively or negatively affected by current market conditions. Because the issuing company has invested their premium to ensure it can pay them the rate guaranteed in their contract, it could lose money if it had to sell those investments at a discount to refund their premium plus their earnings. The reverse can also be true.

RISK FACTOR

The market value adjusted annuity serves to protect the insurance company against investment losses incurred by early withdrawals. By having a more predictable pattern of withdrawals, MVA annuities have a greater potential to credit higher interest rates than the traditional fixed annuity.

As with equities, bonds and variable annuity products, market value adjusted annuities can provide opportunities for market gain. But they also offer the security found in traditional fixed deferred annuities, typically with no extra sales or administrative fees.

In a declining interest rate environment, the annuitant has the security of a guaranteed rate common to fixed annuities.

In addition, due to the mechanics of the MVA feature, much like a bond, the market-adjusted value of the product actually increases as interest rates decline. In this environment, the credited rate should be better than new money alternatives, which showed a decline since the annuity was issued.

On the other hand, in an increasing rate environment, as with a bond, the market-adjusted value of the contract may decrease. Here is where insurers start to differ with product architecture: One sells a market value adjusted annuity where, unlike a bond, the annuitant is guaranteed the surrender value will never be less than premium paid accumulated at minimum guaranteed interest, less applicable surrender charges.

INHERITANCE ANNUITY

If an annuitant dies before the term of their annuity contract ends, the designated beneficiary will inherit the annuity investment—this situation is known as an "inheritance annuity." Both qualified and nonqualified annuities can be inherited.

As you know, a qualified annuity is a financial investment connected to retirement plans, including death benefit pensions, tax-sheltered annuities—also referred to as 403(b) plans—and IRAs, and is paid with pre-tax dollars. An annuitant's spouse can roll all assets from the qualified annuity into another plan and treat it as their own. This also includes a 401(k). If not a spouse, the annuity payment will be disbursed as a lump sum or can be set up as a separate IRA account to receive the money once inherited. A nonqualified annuity is an investment purchased outside of a work-related retirement plan using after-tax dollars. These annuities have already been subject to income tax; however, any interest earned will be taxed upon withdrawal. If a beneficiary inherits this type of annuity, they will be required to pay taxes on the growth.

DISTRIBUTION OPTIONS FOR AN INHERITED ANNUITY

Lump Sum Payment — The designated beneficiary can receive the full death benefit as a one-time lump sum payment upon the annuitant's death. A lump sum payment provides the beneficiary with the flexibility to pay off debt and larger expenses at one time.

Five-Year Rule — The five-year rule requires the inherited beneficiary to receive the full distribution within five years of the annuitant's death. The beneficiary can take smaller amounts during the five-year period until the full annuity has been disbursed, take the full annuity at the fifth year, or take all disbursement payments immediately following the annuitant's death. The five-year rule is the only disbursement option available to estates, charities or trusts named as beneficiaries.

Periodic Payments — Inherited beneficiaries can choose to receive a single life or term certain annuitization option. In a single life annuity payout, proceeds are disbursed until the annuitant's death. If there is still a balance after their death, the remaining balance is surrendered to the insurance company. In a term certain annuity payout, annuity payments are disbursed for a fixed period of time. Once the term has ended, the inherited annuitant will receive no more payments even if they are still alive.

Options for the Surviving Spouse

Distribution options will vary depending on if the beneficiary is the surviving spouse or someone other than the surviving spouse. The surviving spouse has several options, but the most common is to treat the annuity as their own, keeping all the options the owner had.

Annuities can be structured in a wide variety of ways, so options will vary on the particular annuity structure negotiated with the annuity provider at the time of the sale. Some options include whether or not to include the spouse as a beneficiary, when to begin payments, and how long the payment stream will continue.

Options for Non-Spouse Beneficiaries

For beneficiaries who are not the surviving spouse, there are three potential options:

- Lump sum payout,
- Full payout over the next five years, or
- Elect within 60 days to annuitize over their own lifetime.

If the annuity payments have already begun, payments must be taken at least as rapidly as the original owner was taking them.

Taxation of an Inherited Annuity

Inherited annuities come with a number of tax implications, especially if the inherited beneficiary is not the spouse. If the beneficiary is a spouse of the deceased annuitant, they can carry on with the original annuity contract without any immediate tax implications.

However, if the beneficiary is not a spouse, the taxes depend on the payout choice. If the non-spouse beneficiary chooses a lump sum payout option, they will owe taxes on the interest earned on the original premium. They will not have to pay income tax on the premium. If the beneficiary chooses to continue with annuity payments, each payment will be taxed individually. Choosing this option spreads out the tax liability over a longer period of time.

This may be especially beneficial because an annuity is considered a financial asset in the deceased’s estate, and is therefore subject to estate tax. The annuity beneficiary will be responsible for paying this estate tax.

When a person inherits an annuity, the gains stay with the policy. Depending on the type of annuity, the tax will have to be paid on the lump sum received or on the regular fixed payments. The payments received from an annuity are treated as ordinary income, which could be as high as a 37% marginal tax rate depending on the beneficiary's tax bracket.

Supposing that this annuity was purchased with after-tax dollars, ordinary income is owed on all gains but not on the earned principal. A portion of each annuity payment will be considered a tax-free return of principal, spreading the tax liability out over time, unless the lump-sum payout is selected.

A lump sum distribution is a one-time payout of a plan, instead of having the payout broken into several smaller payouts made over time. Lump sum payments can have tax implications.

According to the IRS, a lump sum distribution is a distribution that is paid:

- Because of the plan participant's death;
- After the participant reaches age 59½;
- Because the participant, if an employee, separates from service; or
- After the participant, if a self-employed individual, becomes totally and permanently disabled.

Tax obligations may possibly be deferred by rolling the lump sum distribution over into an individual retirement account. According to the IRS: "You should receive a Form 1099-R from the payer of the lump sum distribution showing your taxable distribution and the amount eligible for capital gain treatment. If your Form 1099-R isn't made available to you by January 31 of the year following the year of the distribution, you should contact the payer of your lump sum distribution."

SELLING AN INHERITED ANNUITY

While receiving monthly, quarterly or annual payments may be beneficial, some inherited annuitants may choose to sell their annuity to pay for certain expenses, such as emergency expenses, tuition, or to alleviate debt.

Inherited annuitants have the added option to sell their inherited annuities in one of two ways.

Partial Sale – Annuitants can sell a period of their annuity disbursement or they can sell a portion of each payment. If the annuity payments last ten years, beneficiaries

can sell years of their payments in exchange for a lump sum. After that term, they will begin or continue to receive the remaining payments. Beneficiaries can also sell a portion of each payment in exchange for a lump sum and a smaller continual payment.

Entirety – Inherited annuitants can sell all their continual payments through the term of the annuity contract. In exchange for this transaction, the beneficiary will receive a one-time lump sum payment.

TAX SHELTERED ANNUITY (TSA)

If a person works for a public school or certain tax-exempt organizations such as religious, charitable, educational, scientific, and literary organizations described in Internal Revenue Code, IRC, Sec. 501(c)(3), they may be eligible to participate in a tax sheltered annuity (TSA) retirement plan offered by their employer. TSA plans are commonly referred to as 403(b) plans. TSA participants can invest funds in annuity contracts, custodial accounts holding mutual fund shares, or retirement income accounts (for certain plans maintained by churches). Special rules apply to figure the cost of the life insurance premiums paid to cover any incidental life insurance protection.

Under Section 403(b) of the Internal Revenue Code, private or public school personnel and members of charitable, educational, tax-exempt, religious, or nonprofit organizations are eligible for TSAs. A tax sheltered annuity is comprised of the following components.

- It is purchased from an insurance company.
- Contracts are issued to either an individual or a group.
- The participant may choose a variable, fixed, or combination plan.
- The participant’s contributions may vary yearly.
- The insurance carrier receives deposits directly from the employer.
- Contributions are outlined in a salary reduction agreement.
- Contributions are made via payroll deductions on a pre-tax basis.
- Social Security tax (FICA) is withheld on the employee’s salary deduction amounts.

SETTING UP A TSA

No individual can set up their own TSA—only their employer can. But typically the employee agrees to have their salary reduced by the amount to be contributed. If the employer contributes its own funds, the arrangement is subject to many of the same rules that govern regular qualified plans.

A TSA can be set up at any time during the year. However, the employee must enter into the salary reduction agreement before the reduced amounts are available to the employee. An employee can later modify their deferral amount, but only with respect to future income.

CONTRIBUTION LIMITS

Generally up to 100% of compensation can be contributed, not to exceed a specified amount that is adjusted annually. If it is desirable to use past service as a contribution base, then it is often possible to exceed this limit. However, the rules are very complex and depend on the actual facts. Other limits may also be imposed.

WITHDRAWAL OPTIONS WITHOUT PENALTIES

Under certain circumstances, money may be withdrawn without penalty, such as a financial hardship, disability, termination of employment or, of course, death.

PLAN INVESTMENTS

Assets in a 403(b) plan can be placed in any of the following investment types:

- An annuity contract provided through an insurance company;
- A custodial account invested in mutual funds; or
- A retirement account set up for eligible employees.

INDIVIDUAL AND GROUP CONTRACTS COMPARED

If the participant is participating under a group contract, he/she will receive an individual certificate of verification. Since the actual contract is between the participant's employer and the insurance company, a group contract differs from an individual contract.

With an individual contract guarantees exist until the contract ends. The participant can take the contract with him/her when they change jobs without any penalty.

With a group contract, the guarantees last for only a certain period of time.

Several options are available to a participant who changes employment. He/she can:

- Freeze the account;
- Transfer all or part of the program to one offered by a new employer, providing the new employer is eligible to participate in a TSA program; or
- Transfer all or part of the monies to an IRA.

There should be no tax consequences if the changeover is properly made.

BENEFITS OF CONTRIBUTING TO A TSA

First, one does not pay income tax on the contributions they make in the year that they are made. They are either excludable or deductible from one's income. Taxes on the amounts contributed are not taxed until retirement, when most people plan to begin distributions to supplement their income. Second, earnings and gains within the TSA are not taxed until they are withdrawn. Third, participants may be eligible to take credit for elective deferrals that they contribute to their TSA.

CONTRIBUTION METHODS

The IRS limits the annual amount of total contributions allowed. In addition, the insurance company sets guidelines on the amounts of contributions allowed even though the employee makes the majority of all contributions.

The employee's contribution amount is calculated based on a percentage of pay and is deducted from the employee's paycheck and sent to the insurance company on a bi-weekly, semi-monthly or monthly basis.

Generally, only an employer's payroll mechanism can make contributions to a 403(b) account. However, some plans will allow participants to make after-tax contributions. The following types of contributions can be made to 403(b) accounts:

Elective deferrals — When an **employee** contributes to a TSA or 403(b), it is called an elective deferral. These are contributions made under a salary reduction agreement. This agreement allows the employer to withhold money from the employee's paycheck to be contributed directly into a 403(b) account for the employee's benefit. Taxes are not due until funds are withdrawn from the account.

Non-elective contributions — These are **employer** contributions that are not made under a salary reduction agreement. One cannot pay tax on these contributions until

they are withdrawn from the account. Non-elective contributions include matching contributions, discretionary contributions, and mandatory contributions from their employer.

After-tax contributions — These are contributions they make with funds that they must include in income on their tax return. A salary payment on which income tax has been withheld is a source of these contributions. If their plan allows them to make after-tax contributions, these are not excluded from income and they cannot deduct them on their tax return.

The three methods of contribution can be combined as well.

TRANSFERS

Contributions may also be made by transferring funds from one company to another or from one subaccount to another offered by the same insurance company. Reasons for implementing transfers:

- The portfolio performance of the current company is unsatisfactory;
- Employment change;
- The participant's new employer does not have a TSA;
- Ability to take risks has changed; and
- Retirement date has changed.

ALLOWED INVESTMENTS FOR 403(b) FUNDS

There are three choices:

- Annuities (fixed or variable and individual or group);
- Custodial accounts invested in mutual funds; or
- Combination of whole life insurance and annuities.

REQUIRED MINIMUM DISTRIBUTIONS

Generally, a person withdraws their funds at retirement. In order for them to avoid penalties, their withdrawals must begin in the calendar year during which they became age 72 or, if later, the calendar year during which the employee actually retires. At a minimum, the funds must be taken out over the life expectancy of the person and, if desired, his or her spouse.

The required minimum distribution for any year is the account balance as of the end of the immediately preceding calendar year divided by a distribution period from the IRS's Uniform Lifetime Table. A separate table is used if the sole beneficiary is the owner's spouse who is ten or more years younger than the owner.

Again, a qualified annuity acts like any other qualified account such as an IRA, 401(k), profit sharing plan or other tax-deferred retirement account and is taxed the same in almost all cases. The government does not require you take any money out prior to age 72 but should you do so, all that you take out is subject to ordinary income tax and if prior to age 59½ it is generally subject to an additional penalty (excise) tax of 10%. At age 72 minimum withdrawals must begin. The amount required is different based generally on the annuity's account balance and the age. However, there are additional details to consider and, again, a tax professional should be consulted.

Note: Prior to the passage of the SECURE Act in 2019, the minimum age for distributions to begin was 70½. (You will learn more about the SECURE Act as we proceed through the course material.)

PREMATURE WITHDRAWAL PENALTY

There is a 10% IRS penalty for withdrawals prior to age 59½, and all gain withdrawn is taxed currently as ordinary income unless the distribution is rolled over or transferred to another TSA; or unless the annuitant is totally disabled, separates from service (after age 55), or dies. Also, a person's salary reduction amounts (but not the earnings) are available for financial hardship; e.g., an immediate and heavy financial need that cannot be met with other assets.

TSA LOANS

Participants can borrow funds from their TSA and later restore them without incurring a tax if established conditions are met regarding maximum loan amount, amortization requirements, time period for repayments, etc.

Some insurance companies permit loans from the TSA. However, the IRS also governs loans. Generally, loans are limited to the lesser of 50% of the vested account balance or $50,000.

The IRS governs TSA loans in the following manner.

- A loan is taxable if it exceeds 100% of the employee's account or $10,000, whichever is less, if the account is less than or equal to $10,000;
- A $10,000 or greater loan will be taxed if the participant's account is more than $10,000 but less than $20,000;
- If the value of the account is over $20,000, a loan will be taxable if the amount of that loan is 50% of the value of the account, or $50,000 whichever is less. The $50,000 amount referred to here is reduced by any net loan repayments made by the employee during the preceding 12 months;
- Loans, with the exception of real estate related loans, must be repaid within five years;
- Should the loan not be repaid in time, any amount that is still outstanding will be immediately subject to taxation. It may also be subject to a 10% tax penalty;
- If a loan is in default, the insurance company is required to notify the IRS and the participant.

Should the loan ever exceed the value of the employee's account, any excess is taxed.

Remember, if the loan is not repaid as required, the IRS treats it as a distribution rather than a loan. In addition, the 10% withdrawal penalty may be charged if the recipient was not age 59½ at the time of the loan.

PROTECTION FOR THE CONSUMER

It is suggested that the borrower contact his insurance company to discuss possible safeguards, since TSA loans have the potential for adverse tax and penalty consequences. In addition, late payments should be avoided as they can be termed as a technical default. Technical defaults allow the insurance company to deduct payments due from funds in the account; thus putting the participant in a withdrawal situation due to the forced payments. (Failure to repay a loan is treated as a distribution.)

DIFFERENCES BETWEEN TSAS AND REGULAR ANNUITIES

TSAs contribute before-tax dollars and other annuities are funded with after-tax dollars and the TSA is only available to certain employment classifications.

TAX SHELTERED ANNUITY EXPENSES

It is important to note that virtually every tax-sheltered annuity has expenses. Insurance companies obtain fees as **explicit** or **implicit**.

Explicit charges are clearly defined and direct, and they are often much lower than implicit charges. Under the following circumstances, these charges may be applied regularly throughout the year:

- At time of account valuation;
- At receipt of contribution;
- At time a loan is made;
- At time of a withdrawal.

Implicit charges are made indirectly. The difference between the returns actually earned by the insurance company and the amount credited to the account could produce an implicit charge.

TAX SHELTERED ANNUITY AMENDMENTS

A TSA contract, with the permission of the participant, can be amended in a rather broad manner. Amendments can affect the amount of any charges made, future credited interest, annuity rates per $1,000 annuitized and many other provisions in the contract.

DEATH OF A TSA PARTICIPANT

If a participant with a TSA dies, the proceeds become a part of their taxable estate for federal estate tax purposes, and they are considered ordinary income to the beneficiary, except for any “pure” insurance proceeds that might be a part of the death benefits.

TRANSFERS

A participant is allowed to transfer their funds from one 403(b) investment to another and it will not be considered a taxable distribution if the funds remain subject to the distribution restrictions on the prior investment. If a TSA is rolled directly into an IRA, it will defer taxation. If it is paid to the participant first, it will be subject to the mandatory 20% income tax withholding rule.

CHARITABLE GIFT ANNUITIES

Many nonprofit organizations that depend upon federal funding for a large part of their operating budgets are experiencing reductions from that source. Income-tax levels are becoming increasingly punitive, and people are looking for legitimate forms of tax relief. Additionally, more and more Americans are facing the probability that Social Security will be an inadequate "safety net" for their retirement. These concerned people are looking for tax-favored ways to augment their future retirement incomes.

Charitable gift annuities (CGAs) provide one solution to these concerns. A gift annuity offers immediate tax relief and has the potential to provide some tax-free retirement income. In exchange for the gift contributions made to a charity, the charitable institution guarantees a retirement income, either immediate or deferred, which can last for the entire lifetimes of the donor and spouse. In addition to the economic advantages, the donor can experience the satisfaction of seeing a part of the proceeds of a gift put to immediate use in a charitable institution. A CGA, which is reinsured with an immediate annuity, provides the charity with the advantage of immediate access to a significant portion of its gift proceeds.

HOW CHARITABLE GIFT ANNUITIES WORK

A charitable gift annuity is one of the easiest forms of planned giving. In exchange for an immediate gift to a legitimate 501(c)(3) charity, the donor is promised a specified lifetime income. The exact amount of that gift is agreed upon at inception. Typically, the life income goes to the donor or is shared as a 100% joint and survivor option to the donor and spouse. The arrangement is that simple. There is an agreement of understanding between the donor and the charity. The charity's stability and reputation provide peace of mind to the donor. If the charity ceased to make the agreed upon payments, the donor would be a primary creditor against that institution. Obviously, a century old establishment such as a nonprofit hospital or major community church would have an easier time attracting a charitable gift annuity donor than would a recently established organization.

An individual may make a "gift" or "donation" to a nonprofit or educational organization and in return receive an income for life and multiple tax deductions.

THE GIFT AND TAX DEDUCTION

An individual or couple may fund a charitable gift annuity with cash and marketable securities.

Cash — Cash donations to fund a charitable gift annuity entitle the donor to claim a charitable income tax deduction in an amount of up to 50% of their adjusted gross income. If the gift is greater than 50% of their income in the year in which it is made, the donor may carry the balance forward for up to five years.

Securities — Securities used to fund a charitable gift annuity provide the donor with a unique advantage. If the securities have been held for more than one year, the charitable income tax deduction is based on the market values of the securities. They may claim a charitable income tax deduction of up to 30% of their adjusted gross income. If the gift is greater than 30% of their income in the year in which it is made, the donor may carry the balance forward for up to five years.

Income — Once the gift has been made, they can elect to defer the income or chose to have it begin immediately. One advantage of a charitable gift annuity is that it creates a guaranteed income at a guaranteed rate of return. Most organizations use the table set by the American Council on Gift Annuities (ACGA) to determine the maximum rate that can be paid to them. Based on the IRS rules for gain recognition, a part of each payment is not taxable. This is known as the exclusion allowance and is based on life expectancy.

EXAMPLES OF A CHARITABLE GIFT ANNUITY

Gift based on a single life — Mr. Bill Samuels, who is 70 years old, has decided to donate $50,000 to his college as a gift annuity. The reasons Mr. Johnson chose a gift annuity are as follows:

- The college receives a gift of $50,000;
- Mr. Johnson receives a guaranteed lifetime income;
- Mr. Johnson receives an immediate tax deduction; and
- Mr. Johnson's $50,000 gift is no longer part of his estate.

When Mr. Johnson makes the gift to the college he will receive a guaranteed annual income of $3,750 for the balance of his life, based on the rate recommended by the American Council on Gift Annuities (ACGA).

In the year in which he makes the donation to the college, he will receive a tax deduction in the amount of $19,857. This amount is based on an IRS discount rate of 7.2 percent (7.2%); however, each month the IRS sets the discount rate—check with the IRS for the current discount rate.

When Mr. Johnson receives his annual income, of $3,750 he pays taxes only on a portion of this income, $2,491 of the $3,750 is not taxable over his life expectancy.

Gift based on two lives — Mr. and Mrs. James Allison have chosen to make a $50,000 gift to Mrs. Allison's college. However, they would like the guaranteed income to be paid to either Mrs. Allison or Mr. Allison for as long as either one of them is living. When Mr. Allison (older beneficiary) makes the gift to the college, Mr. and Mrs. Allison receive a tax deduction in the amount of $19,857.

The annual income paid to Mr. Allison and Mrs. Allison is $3,350, which will continue to Mrs. Allison should Mr. Allison pre-decease Mrs. Allison. This annual income will continue until Mrs. Allison's death.

When Mr. and Mrs. Allison receive their annual income of $3,350, Mr. and Mrs. Allison will pay taxes only on a portion of the income. $1,530 of the $3,350 will not be taxed over their joint life expectancy.

IMPAIRED RISK ANNUITIES

With an impaired life annuity, the annuitant's insurance age is RATED to be OLDER than their actual chronological age. This is advantageous since the monthly income based on a rated or older age is higher than the income calculated using the person's actual age, given the same deposit amount. The insurance company pays a higher monthly income for an impaired life because the annuitant is not expected to live as long as the average person of the same chronological age.

The shorter the life expectancy,
the higher the monthly income!

With this type of annuity, the annuitant provides the insurance company with an attending physician's statement (APS) and/or hospital records for review. A short time later the insurance company will offer a "standard" rate if the medical history does not influence their mortality tables, or they will offer a "rated age" if they feel the medical history of the annuitant warrants a shorter life expectancy. The rated age would be older than the annuitant's actual age.

Since the payout or income from the annuitant's deposit is partly determined by age, the payout or income would be higher than it would be if the actual age were used for the calculation. For this reason, it is beneficial to provide as much medical

information as possible to the insurance company in order for them to give a fair assessment.

Payments can actually be geared higher to begin with if one is not healthy. Impaired risk underwriting is a process by which physicians or underwriters evaluate the life expectancy of an individual based on his or her health. Individual medical conditions are considered and a variety of risk factors including high blood pressure, heart disease and diabetes can result in a reduced life expectancy. The longer the life continent element of the annuity, the greater the potential savings to the consumer." (Or in layman's terms, if you are not going to live that long, your payout for dollar invested will be higher than normal since you are going to die sooner than the average individual.) "So impaired risk annuities can benefit consumers by either reducing the premium for a specific stream of payments or by providing an increased benefit for the same premium."

Examples:

Assume a woman age 70 wants a guaranteed $1,000 a month for retirement. She is not in good health. Based on her medical condition, she has a life expectancy of a 74 -year-old. A regular annuity would cost $159,204. But due to her condition, it would cost only $142,560.

Or, assume a man age 65 has a single premium deferred annuity with a cash value of $125,000. If he buys a single premium immediate annuity with a 10-year certain and life option, he would get $1,048 based on his life expectancy of a man at age 70 due to his medical conditions. As a normal person age 65, he would have received $960.

Not all companies that offer immediate annuities will offer impaired immediate annuities.

Generally, the funds from those annuitants who die young go towards paying for those who live longer than expected. If one of these companies were to enter into the impaired annuity market it would be jeopardizing its competitiveness in its core area.

By offering enhanced rate annuities alongside standard rate annuities, the company's cross-subsidy system would weaken. This is because impaired annuitants, who receive significantly higher annuity payments than their standard annuity counterparts, would obviously opt for these products, thereby removing the existing cross-subsidy that provides for healthy annuitants.

This would cause a natural downward adjustment to the annuity rates offered to the company's non-impaired risk group—and, as a result, the company would lose some of its competitive edge.

- **All impaired risk annuities are immediate annuities**
- **Impaired risk annuities have larger income payout**

BONUS ANNUITIES

Bonus annuities are fixed or variable annuities that offer the contract owner a bonus rate in addition to the regular return. Upfront premium bonuses are typically found with fixed indexed annuity products, while first year interest rate bonuses are usually attached to traditional fixed annuities.

Bonus annuities pay a bonus rate in addition to the regular payment amount (base rate). The "base rate" is the interest rate that the company projects it will pay in the second year and thereafter, but is NOT guaranteed in most cases.

Some annuities will offer a **premium bonus** instead of a first-year bonus. Quite often, the renewal rate a company declares on each contract anniversary from the second year and beyond is different than the projected base rate.

The **first year bonus** is the most common. This annuity usually offers a higher first-year interest rate, which is guaranteed for one year. The **base rate** is the interest rate that the company projects it will pay in the second year and thereafter, but is NOT guaranteed in most cases. The difference between the actual rate in the first year and the projected base rate for subsequent years is the **bonus rate**. Quite often, the **renewal rate**, which a company declares on each contract anniversary from the second year, is different than the projected base rate. The first year bonus is used as an inducement to save (without a large sum of money to contribute to an annuity) will be more motivated by a smaller bonus on all premiums paid for a number of years. Some annuity contracts will offer a premium bonus of as high as two percent (2%) for the first five years of premium payments.

The bonus amounts calculated based on the bonus feature will be paid in addition to the initial rate and may or may not be forfeited depending on the contract provisions. In many cases, a bonus rate of interest is forfeited if a person takes the money either prior to the end of the surrender period or earlier than a stated policy year of the contract. Generally, the larger the bonus the more restrictive the surrender terms will

be on the bonus amounts. Some annuity products will stipulate that the bonus amounts are forfeited if the contract is not annuitized. Some annuity contracts will begin a multi-year vesting period after the traditional surrender period is over.

For example, if the annuity has a seven-year surrender period, the bonus amounts may vest at 33 1/3 percent (33 1/3%) per year in years eight through ten (8-10). The multi-year vesting schedule is designed to increase persistency.

The majority of the time, a “bonus” is advertised as a means to offset the surrender charges an annuity faces when they move an annuity from one carrier to the other.

UPFRONT PREMIUM BONUS

With the upfront premium bonus, the insurance company credits the annuity based upon a certain percentage of the premium deposit initially made, or when additional funds are deposited. For example, if Susan initially places $100,000 into an annuity that offers a five percent (5%) upfront premium bonus, the insurer would immediately add an extra $5,000 to her annuity, making the value of the account $105,000 on the issue date of the policy.

FIRST YEAR BONUS

The most common type of annuity bonus is a first year bonus, which offers a higher first-year interest rate, which is usually guaranteed for one year. The "base rate" is the interest rate the company projects it will pay in the second year and thereafter, but this rate is NOT guaranteed in most cases. The difference between the actual rate in the first year and the projected base rate for subsequent years is the bonus rate. Quite often, the renewal rate a company declares on each contract anniversary date beginning in the second year is different than the projected base rate. The first year bonus is used as an inducement to move large blocks of money into an annuity.

ANNUITIZATION BONUS

Some annuities offer an annuitization bonus to encourage annuitization. While the terms of annuitization bonuses vary from one annuity to another they do share common characteristics such as:

- A requirement for a minimum holding period before the bonus is available;
- A set amount (usually expressed as a percentage of the contract value) is added to the annuity value when annuitized (i.e., 2% added after the fifth contract year, OR 1% added per contract year up to a maximum of 10%);

- Minimum annuitization time period required (usually at least five-year period certain…some require lifetime annuitization).

VESTING OF BONUS AMOUNTS

The bonus amounts calculated based on the specific bonus feature will be paid in addition to the current rate; it may or may not be forfeited, depending upon the contract provisions. In many cases, a bonus rate of interest is forfeited if the annuitant withdraws funds prior to the end of the surrender period or earlier than a stated policy year of the contract.

Generally, the larger the bonus the more restrictive the surrender terms on the bonus amounts. Some annuity contracts stipulate that the bonus amounts are forfeited if the annuitant makes withdrawals without annuitizing the contract. Other contracts begin a multi-year vesting period after the traditional surrender period has expired. For example, if the annuity has a seven-year surrender period, the bonus amounts may vest at 33 1/3% per year in years eight through ten. The multi-year vesting schedule is designed to increase persistency.

MULTI-YEAR GUARANTEE ANNUITIES

A multi-year guarantee annuity is much like a certificate of deposit. Multi-year guarantee annuities (MYGAs) are a type of annuity in which the interest rate is guaranteed in advance for a set number of years. Because interest is credited annually and reinvested in the annuity and taxation is deferred until interest withdrawals begin, it's commonly referred to as a fixed deferred annuity.

MYGAs come with several different names (i.e., CD-type annuities, tax-deferred CDs, bonus annuities).

- MYGAs typically offer higher interest rates than bank CD's for the same period of time.
- MYGA interest earnings are tax-deferred when compounded.
- MYGAs can be purchase with both nonqualified and qualified IRA funds.
- MYGAs provide liquidity options for penalty free and systematic withdrawals.

The key advantages of owning a multi-year guarantee annuity include safety of principal, tax deferral, set interest rate each year, no fees, and annual penalty-free withdrawal of principal.

KEY QUESTIONS WHEN CONSIDERING AN MYGA ANNUITY

Does the annuity have a locked-in and guaranteed interest rate for the entire rate period, or can the rate change after the first year? If so, what will that rate be?

- Are withdrawals permitted during the term of the annuity?
- Does interest compound?
- Is the growth on the funds taxed?
- Are there any associated fees?
- What happens to the funds if the consumer passes away prematurely?
- Is the annuity insured?[22]

DEFERRED INCOME ANNUITY

Though we have briefly touched upon this type of annuity earlier in this course material, now is the time to elaborate.

A deferred income annuity (DIA) is designed to provide a guaranteed lifetime income stream beginning at a predetermined future date, from a few years and up to 40 years in some cases. Usually, the income payout will be significantly higher than with an immediate annuity. These annuities will pay an income for life as well; however, only after the consumer has reached a certain age. For instance, an annuitant who is 65-years of age today can purchase a DIA that has a payout period of 20 years with payout to begin at age 75. That means the annuitant will not receive any payments for another 10 years after the annuity issue date, but he will receive the income generated until he's 95 years of age. If death comes prematurely, payments revert to the named beneficiary.

The DIA has two main phases: the savings phase and the income phase. The savings phase is when money is invested in the account. The income phase is when the annuity begins payout.

Deferred income annuities essentially combine the benefits of both annuities and life insurance. The DIA contains **mortality credits**, which allow annuities to pay out income for long periods of time to those who live long lives. Mortality credits are created when people die sooner than expected and don't receive as many income payments as they would have if they had lived their full life expectancy. That money

[22] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

goes into a pool that will then pay lifetime income to those people who live longer than their life expectancy.

The deferred income annuity is a good choice for those individuals who have a family history of life longevity, and therefore are likely to follow suit. The DIA owner should have their immediate income needs and emergency funds already in place. Other key points for DIA candidates include individuals who:

- Have a need to supplement income later in their retirement years;
- Seek a substitute for pension income; and
- Worry about needing long-term care in the future, but who do not have long-term care insurance coverage or any other plan in place to pay for those potential expenses.[23]

KEY QUESTIONS WHEN CONSIDERING A DEFERRED INCOME ANNUITY

- If the consumer chooses to start the income in ten years, can he/she later change their mind and begin the income on a different date?
- Does the consumer have the ability to add to the annuity so that future income can be greater?
- What are the tax implications of a deferred income annuity?
- Does the consumer need to be concerned if the stock market is going up or down when he chooses to turn the income on?[24]

LIVING BENEFIT ANNUITY

This annuity is a special type of variable annuity, which is also known as a "Guaranteed Retirement Income Benefit" (GRIB). The best living benefit annuities guarantee at least a five percent (5%) return over seven years, or the highest attained value on each anniversary during the surrender period, whichever is greater. However, in exchange for this living guarantee, the living benefit annuity has a surrender charge, or penalty for early withdrawal, no upfront bonus, and a slightly higher annual fee.

The basic death benefit offered by a variable annuity is a guarantee that after the annuitant's death, the contract beneficiary will receive at least the amount paid into

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[23] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

[24] Annuity Buyers Guide, https://www.annuityadvantage.com/lp/resources/Annuity_Buyers_Guide.pdf

the contract (minus any withdrawals). The living benefit annuity, commonly referred to as a contract rider, creates an **enhanced death benefit**. A rider may be purchased which locks in a guaranteed income stream regardless of market performance.

ANNUITIES IN THE CONTEXT OF DEFINED CONTRIBUTION PLANS

A defined contribution plan is a tax-deferred retirement plan, like a 401(k) or a 401(b), in which employees contribute a fixed amount or a percentage of their pay to an account that is intended to fund their retirements. The sponsor company will at times match a portion of employee contributions as an added benefit. These plans place restrictions that control when and how each employee can withdraw from these accounts without penalties.

Many employers have moved away from defined benefit pension plans to offer 401(k) or other defined contribution plans instead. Defined benefit pension plans and defined contribution plans differ, among others, in the allocation of such risks as job turnover risk, investment risk, and longevity risk. For example, a defined benefit plan generally pays a fixed benefit for the life of a retired worker, irrespective of investment market fluctuations before or after retirement. This implies that the investment and longevity risks are borne by the plan and not the retiree. In contrast, a retired worker who draws from his defined contribution plan shoulders both investment and longevity risks himself.[25]

Annuities may play a role in defined contribution plans through several avenues.

- Plans may offer a deferred annuity among their investment options;
- Plans may offer the option to annuitize the account balance (invested in any type of security) upon retirement;
- Some plans offer the option of a lump sum distribution upon job separation, which may be rolled over into an IRA and used to purchase an annuity.

When a worker who is covered by a defined contribution plan separates from his job, he typically has several options of what to do with his plan assets.

- He can leave the assets in the former employer's plan.
- He can take a cash distribution.
- He can convert the balance into an annuity.

[25] dol.gov, *Annuities in the Context of Defined Contribution Plans*, Nov. 2011

- He can roll the balance over to an Individual Retirement Account (IRA).

TAXATION OF DEFINED CONTRIBUTION PLAN

A defined contribution plan is a plan in which you have an individual account. Benefits are based only on the amount contributed to the account and the income, gains or losses, etc., which may be allocated to that account. Under a defined contribution plan, contributions (and income allocable to those contributions) may be treated as a separate contract for figuring the taxable part of any distribution. The employer contributions (and income allocable to those contributions) wouldn't be considered part of that separate contract.

Example:

Ryan participates in a defined contribution plan that treats employee contributions and earnings allocable to them as a separate contract. He received a non-annuity distribution of $5,000 before his annuity starting date. He had made after-tax contributions of $10,000. The earnings allocable to his contributions were $2,500. His employer also contributed $10,000. The earnings allocable to the employer contributions were $2,500.

To determine the tax-free amount of Ryan's distribution, use the same formula shown, earlier. However, because employee contributions are treated as a separate contract, the account balance would be the total of Ryan's contributions and allocable earnings.

Thus, the tax-free amount would be $5,000 × ($10,000 ÷ $12,500) = $4,000. The taxable amount would be $1,000 ($5,000 - $4,000).

If the employee contributions weren't treated as a separate contract, the tax-free amount would be $2,000 ($5,000 × ($10,000 ÷ $25,000)) and the taxable amount would be $3,000 ($5,000 - $2,000).

PLANS THAT PERMITTED WITHDRAWAL OF EMPLOYEE CONTRIBUTIONS

If you contributed before 1987 to a pension plan that, as of May 5, 1986, permitted you to withdraw your contributions before your separation from service, any distribution before your annuity starting date is tax free to the extent that it, when added to earlier distributions received after 1986, doesn't exceed your cost as of December 31, 1986. Apply the allocation described in the preceding discussion only to any excess distribution.

Distribution Before Annuity Starting Date From a Nonqualified Plan

If you receive a nonperiodic distribution before the annuity starting date from a plan other than a qualified retirement plan (nonqualified plan), it is allocated first to earnings (the taxable part) and then to the cost of the contract (the tax-free part). This allocation rule applies, for example, to a commercial annuity contract you bought directly from the issuer. You include in your gross income the smaller of:

- The nonperiodic distribution, or
- The amount by which the cash value of the contract (figured without considering any surrender charge) immediately before you receive the distribution exceeds your investment in the contract at that time.

Example:

You bought an annuity from an insurance company. Before the annuity starting date under your annuity contract, you received a $7,000 distribution. At the time of the distribution, the annuity had a cash value of $16,000 and your investment in the contract was $10,000. The distribution is allocated first to earnings, so you must include $6,000 ($16,000 − $10,000) in your gross income. The remaining $1,000 ($7,000 − $6,000) is a tax-free return of part of your investment.

Exception to Allocation Rule

Certain nonperiodic distributions received before the annuity starting date aren't subject to the allocation rule in the preceding discussion. Instead, you include the amount of the payment in gross income only to the extent that it exceeds the cost of the contract.

This exception applies to the following distributions.

- Distributions in full discharge of a contract that you receive as a refund of what you paid for the contract or for the complete surrender, redemption, or maturity of the contract.
- Distributions from life insurance or endowment contracts (other than modified endowment contracts, as defined in section 7702A of the Internal Revenue Code) that aren't received as an annuity under the contracts.
- Distributions under contracts entered into before August 14, 1982, to the extent that they are allocable to your investment before August 14, 1982.

If you bought an annuity contract before August 14, 1982, and made investments both before and after August 14, 1982, the distributed amounts are allocated to your investment or to earnings in the following order.

1. The part of your investment that was made before August 14, 1982. This part of the distribution is tax free.
2. The earnings on the part of your investment that was made before August 14, 1982. This part of the distribution is taxable.
3. The earnings on the part of your investment that was made after August 13, 1982. This part of the distribution is taxable.
4. The part of your investment that was made after August 13, 1982. This part of the distribution is tax free.

The taxable portion of distributions from nonqualified plans is subject to the net investment income tax.[26]

ANNUITIES WITHIN AN IRA

The jury is out on the question if an annuity is a smart choice in an IRA. For many, it may be a good idea; of course, there are many factors that need to be weighed to make that choice (i.e., age, risk tolerance, desired asset allocation, life expectancy).

If an IRA holds an annuity, the policyowner may or may not have to include its value when figuring required minimum distributions. The kind of annuity held makes a difference.

IMMEDIATE AND LONGEVITY ANNUITIES HELD IN AN IRA

Immediate and longevity annuities have a relatively easy relationship with required minimum distributions. An immediate annuity results in an instant stream of payments, usually paid out over the buyer's life expectancy. A lifetime stream of payments essentially covers the requirement minimum distribution for the portion of the IRA money invested in it.

[26] irs.gov, Publication 575 (2019) Pension and Annuity Income, https://www.irs.gov/publications/p575

Example:

Susan has a $300,000 in an IRA and uses $100,000 to buy an immediate annuity. The $100,000 is turned into a stream of payments and is excluded from the required minimum distribution calculation. Susan would have to figure the required minimum distribution for the remaining $200,000.[27]

Longevity annuities are purchased with a lump sum payment for payouts starting years later. Qualified longevity contracts can be bought with IRA money (up to 25% of retirement account assets or $125,000, whichever is less). Since required minimum distributions are based on nonannuity holdings, the money in an IRA qualified longevity annuity contract is not figured in the IRA's requirement minimum distribution.

Qualified Longevity Annuity Contract (QLAC) — The qualified longevity annuity contract is a variation on the deferred income annuity. It is designed to meet specific IRS requirements so that policyowner's don't need to take required minimum distributions on the assets within the QLAC contract. It allows the delay of required minimum distributions for a portion of IRA funds and thus keeps more money in the IRA longer.

> **"The rules change when you annuitize a contract."**
> – Ken Nuss, CEO

VARIABLE ANNUITIES HELD IN AN IRA

Complications creep in when a deferred variable annuity is held in an IRA. The required minimum distribution depends on whether or not the annuity has been annuitized. Ken Nuss, Chief Executive Officer of AnnuityAdvantage states, "The rules change when you annuitize a contract."

If the variable annuity is simply an asset within the IRA, then its value must be included along with nonannuity holdings when figuring the required minimum distribution. Even if the policyowner is withdrawing some cash from the annuity, its value on the previous December 31 counts for required minimum distribution purposes.

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[27] Kiplinger, RMD Tips: When Your IRA Holds an Annuity, https://www.kiplinger.com/article/retirement/T045-C000-S004-rmd-tips-when-your-ira-holds-an-annuity.html

Once the variable annuity is annuitized, the stream of payments will cover the required minimum distribution for the IRA value represented by the annuity.

If the contract is annuitized after being subject to required minimum distributions, the required minimum distribution in that first year is based on the prior year account balance. But you must ensure that the total payments received during the first year of the annuitized contract are equal to or greater than the calculated required minimum distribution. If they are less, the shortfall from the nonannuity holds in the IRA must be made up. In subsequent years, the money that's tied up in the annuitized contract would be excluded from the IRA's required minimum distribution calculation.

CALCULATING THE REQUIRED MINIMUM DISTRIBUTION FROM AN IRA

Required minimum distributions must start at age 70½ if the policyowner was born before July 1, 1949, and at age 72 if born on or after July 1, 1949. (The change in age was part of the SECURE Act, which was enacted in December 2019.) All that is needed is the policyowner's age at the end of 2020 and the total balance of the traditional IRA accounts as of December 31, 2019. (Balances from Roth IRAs are not included.)

Note: Up until the passage of the SECURE Act (Setting Every Community Up for Retirement Enhancement Act of 2019), distributions were required to begin by April 1st of the year the participant reached age 70½. The SECURE Act, which was signed December 20, 2019, changes the age to 72. The provision applies only to individuals who attain age 70½ after December 31, 2019. Individuals who have reached age 70½ during 2019 or in a prior year do not benefit from this change.

The required beginning date for IRA owners who haven't reached age 70½ by the end of 2019 is April 1st of the year following the year of the owner's 72nd birthday.

Statement of Required Minimum Distribution — If a required minimum distribution is required from an IRA, the trustee, custodian, or issuer that held the IRA at the end of the preceding year must either report the amount of the required minimum distribution to the policyowner or offer to calculate if for them. The report of offer must include the date by which the amount must be distributed. The report is due January 31 of the year in which the minimum distribution is required. It can be provided with the year-end fair market value statement that the policyowner normally receives each year. No report is required for section 403(b) contracts (generally tax-sheltered annuities) or for IRAs of owners who have died.

IRA Interest — Although interest earned from an IRA is generally not taxed in the year earned, it isn't tax-exempt interest. Tax on a traditional IRA is generally deferred until a distribution is taken.

Excess Accumulations (Insufficient Distributions) — If distributions are less than the required minimum distribution for the year, the policyowner may have to pay a 50% excise tax for that year on the amount not distributed as required.

Request to waive the tax — If the excess accumulation is due to reasonable error, and the policyowner has taken, or is taking, steps to remedy the insufficient distribution, they can request that the tax be waived.[28]

[28] irs.gov, Publication 590-B, https://www.irs.gov/pub/irs-pdf/p590b.pdf

KEY POINTS TO PONDER

- The hybrid annuity typically contains a longer surrender period than the fixed annuity.
- CD-type annuities have the same number of years assigned to the interest rate guarantee and the surrender charge period.
- Straight life annuities are the least complex and least expensive of all annuities.
- Two-tiered annuities have three different values: tier-one, tier-two, and surrender value.
- The hybrid annuity is a part-fixed, part-variable annuity; the term “hybrid” is a marketing term coined by the insurance industry in response to the success of the hybrid car movement.
- The market value adjusted annuity serves to protect the insurance company against investment losses incurred by early withdrawals.
- When an employee contributes to a TSA or 403(b), it is called an “elective deferral.” The employer’s contribution is called a “non-elective contribution.”

CHAPTER 6 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. A hybrid annuity is a _____ annuity.

   a) variable
   b) fixed
   c) indexed
   d) part-fixed, part-variable

2. The hybrid annuity typically contains a longer surrender period than the fixed annuity.

   a) TRUE
   b) FALSE

3. Annuity contracts that have a 5-year guaranteed interest rate and a 5-year surrender charge are examples of what type of annuity?

   a) CD-type annuity
   b) Bonus credit annuity
   c) Creditor annuity
   d) Collateral annuity

CHAPTER 7

ANNUITY RIDERS AND WAIVERS

Annuities come with a host of optional features that can be selected for an additional annual fee.

ANNUITY RIDERS

Riders are special additions to the policy provisions that offer benefits not found in the original contract, or that make adjustments to it. These special provisions are, in effect, attached to the policy. Riders are not necessarily found in all policies. Because all riders provide some kind of benefit to the policyowner, an extra premium may be charged for them. The riders typically offer the benefits that they are named after but the triggers, limitations and restrictions must be understood.

LIFE INSURANCE RIDERS

Some annuities offer a life insurance rider as an option when purchasing an annuity. Offering a life insurance rider on an annuity will sometimes (but not always) involve medical underwriting similar to when purchasing a life insurance policy. In light of the recent examples of Stranger Originated Annuity Transactions, look for more annuity issuers to require medical underwriting when a life insurance rider is offered on an annuity.

Unlike most other assets, annuities do not receive a step-up in cost basis at the death of the owner/annuitant; therefore the beneficiary will owe ordinary income tax on all of the earnings in the annuity. If an annuity is being used as a wealth transfer vehicle, the annuity owner may want to consider using life insurance to provide a tax-free death benefit to their annuity beneficiary to help the beneficiary pay taxes on the annuity proceeds. For this reason some annuity companies will offer a death benefit equal to 25% to 35% of the annuity value at death. The reasoning used in determining the amount of the life insurance death benefit is that 25% to 35% approximates the potential tax liability if the beneficiary liquidates the annuity within one tax year.

LONG-TERM CARE BENEFIT RIDER

The long-term care benefit rider is also referred to as an **accelerated death benefit rider**.

A long-term care rider provides long-term care insurance in addition to a steady stream of income. If an annuity holder suffers an illness or injury that requires a home health aide or nursing home care, this feature will cover costs without cutting into the monthly income payments.

In some contracts the trigger for the rider is a determination by the attending physician that the insured is terminally ill and the life expectancy is limited and within the time allocated in the insurance contract. The determination of “life expectancy” is the amount of time the licensed physician expects the primary insured to live. In other cases the insurance contract allows the insured to access funds when the attending physician has stipulated that the patient is unable to perform certain activities of daily lining. The amount allowed is the percentage of the policy face amount the insurance company will 'accelerate' or pay out. The maximum amount is simply the most the company will pay under the rider. It is important to note the amount accelerated is treated like a policy loan, and is deducted from the face amount of the policy along with any accrued interest and administrative fees. This rider can be a valuable feature should you become terminally ill during the term of contract. Proceeds can be used to pay related medical expenses, to prepay funeral expenses or to settle any other outstanding issues prior to an anticipated death.

- **What are the advantages of a long-term care benefit rider?** A very expensive need is covered. According to the U.S. Census Bureau, the need for long-term care will rise substantially with the coming years. The major attraction to an annuity with a long-term care rider is its flexibility and the fact it remains an asset in the client’s portfolio. The client’s money is invested and can be accessed at anytime, thus eliminating the “use it or lose it” fear.

- **What are the disadvantages of a long-term care benefit rider?** This option in variable annuities is very expensive. In some variable annuities, this feature is activated only when the annuitant suffers a serious accident or is diagnosed with a severe medical condition. Some companies sell variable annuity riders that specify a certain period of time before the annuity holder can activate the rider. (Because of the severely rising healthcare costs, many insurance companies no longer offer this rider—for any cost.)

There are several ways these riders are structured. In all three basic approaches, if the annuity is charged a premium for a rider that provides some of the long-term care

benefits, the account value of the annuity also provides part of the benefit. In most annuities with a long-term care rider, the annuity account value can be exhausted in the process, leaving the annuity owner without any remaining annuity values. The three basic approaches to long-term care riders are discussed below.

- **Account Balance First Long-Term Care Approach** — One approach to the long-term care benefit is to first spend the account balance of the annuity to provide the benefit, and then use the insurance that was purchased to provide a tail balance.

- **Account Balance Last Long-Term Care Approach** — Another approach first uses the insurance purchased via the rider premium until it is exhausted, and then begins to exhaust the annuity account value.

- **Coinsurance Long-Term Care Approach** — Yet another approach employs both the account balance and the long-term care insurance purchased with the rider simultaneously. In this case the long-term care insurance pays a portion of the benefit and the account balance pays the remaining amount.

There are differences in the premiums charged for each of these approaches and in the taxation of premiums and annuity account balances as they are liquidated. There are also differences in the immediate long-term care annuity and the deferred long-term care annuity.

IMMEDIATE LONG-TERM CARE ANNUITY

The immediate long-term care annuity, just like any immediate annuity, is purchased with one single premium payment. The insurance company will send the purchaser a specified monthly income payment in return.

Even if the recipient's current health status is not optimal, and even if they are currently receiving long-term care, they can still purchase this type of annuity.

The insurance company converts the single premium payment into a guaranteed monthly income stream for a specified period of time or for the rest of the recipient's life. The amount the recipient will receive every month depends upon the amount of the initial premium, the recipient's age, and the recipient's gender. Since women tend to live longer than men, women generally receive a smaller monthly payment over a longer period of time than do men of the same age.

Deferred Long-Term Care Annuity

Just like an immediate annuity, these annuities are purchased with a single lump sum payment. This type of annuity is generally available to people up to age 85, and they provide a stream of monthly income for a specified period of time.

The annuity actually creates two funds:

1. A fund that provides for long-term care expenses; and
2. A separate cash fund for other uses.

The long-term care fund can be accessed immediately. The separate cash fund becomes available at a later date. Both funds have accessibility limits.

Unlike the immediate long-term care annuity, the recipient's health may play a part in qualifying. Certain health criterion is adhered to as well.

Waiver of Surrender Charge vs. LTC Rider

While most annuities offer some level of waiver of the surrender charge if the annuitant is confined to a long-term care facility (and this is a good thing), the waiver should not be confused with a long-term care rider. The long-term care rider can provide a benefit that will pay for a wider array of long-term care services than the surrender charge waiver applies to (the waiver of surrender charge usually requires confinement).

In addition, the waiver is not long-term care insurance and does not increase the ability of the annuitant to pay for long-term care services beyond what they can withdraw penalty-free form the annuity.

The rider will guarantee either that a certain minimum withdrawal amount can be taken from the annuity for a specified minimum time period or that a certain minimum percent of the account balance can be withdrawn annually for the life of the annuitant. Unlike annuitization, the annuity owner retains some liquidity in the contract plus the account can still be annuitized in the future if the annuitant chooses to do so.

Guaranteed Minimum Withdrawal Benefits in Variable Annuities

Many fixed annuities offer some form of a Guaranteed Minimum Withdrawal Benefit, but the genesis of this benefit is within the variable annuity market.

When GMWB benefits were first introduced with variable annuities, they came in two basic versions, both of which were designed to protect the initial investment in the contract by giving back the initial deposit in the event the market value of the annuity dropped below the original investment amount. However, the annuitant did not get back the principal in a single, lump sum payment. Rather, the payout was made in systematic payments over a period of years. Some products offered withdrawals of seven percent (7%) of the initial balance every year for 14.2 years. Other products offered withdrawals of five percent (5%) per year for 20 years.

If the annuitant elected one of these options and the investments performed well, they may have found additional money left in the contract at the end of the withdrawal period.

Later versions of GMWB benefits began offering withdrawals of five percent (5%) guaranteed for the rest of the annuitant's life. At older ages, because life expectancy gets shorter and shorter, the annuitant is commonly offered higher withdrawal rates.

VARIATIONS OF THE GMWB

One attractive feature of GMWB benefit is that it offers the ability for withdrawal amounts to increase if the future market value goes up or the ability for amounts to be left in the annuity at the end of the withdrawal period, all without annuitization.

Keep in mind, however, what it would take for that to happen. If an annuitant makes withdrawals of five percent (5%) or more from the account, and the annuity itself carries total charges in the neighborhood of three percent (3%), that's a total of eight percent (8%) coming out of the account value every year. Each year that the investment portfolio produces a gross return of less than eight percent (8%), the account value will decrease and, therefore, gross returns in excess of eight percent (8%) are necessary to grow the account value and produce future increases in withdrawal amounts (using the expense and withdrawal assumptions above). As such, these guarantees provide great peace of mind knowing that, even if the account balance goes to zero, income distributions will continue.

Note: All living and death benefits will be discussed in detail in their own chapter.

DISABILITY AND TERMINAL ILLNESS RIDER

Health status — A partial disability benefits rider pays benefits when the annuitant's ability to earn a living has been impaired by a disabling event. The rider pays a certain percentage of the monthly income payment that was originally stipulated in the contract. The income provided is typically paid out with a specified time limit.

Terminal illness — The rider provides a certain percentage payment due to a health condition that shortens the annuitant's life expectancy, typically to one year or less. Surrender charges are waived when this rider is activated.

Unemployment Rider

This rider may include benefits in cases of unemployment. A certain percentage of monthly income is agreed upon when the rider is purchased for a limited time, typically for up to one year.

The benefits from this rider can be combined with another rider, such as the disability rider, or it can be purchased as a stand-alone rider.

Lifetime Income Benefit Rider

With this rider, even if the actual balance in the annuity has been fully depleted, the payments will continue for the rest of the recipient's life—one cannot outlive their money! This rider is suitable for a person who begins taking benefits early with a long life expectancy.

Cost of Living Adjustment Rider

The cost of living adjustment (COLA) rider provides for increases in monthly payments designed to counter the effects of inflation. COLA riders utilize two methods to calculate payment increases.

One is based on the Consumer Price Index (CPI). Annual changes in the CPI are used to determine changes in the annuity's monthly benefit. As the COLA rises, so does the monthly benefit. However, the downside is that if the index reports a "deflation" (negative change), the monthly benefit will decrease.

The other calculation is based on a level percentage increase. By utilizing this method, monthly payments will never decrease. However, if the CPI rises to four percent (4%) and the contract owner chose a three percent (3%) percentile, the monthly benefit would be less than with the CPI method.

Refund or Return of Premium Rider

In addition to the living benefits that are paid by the annuity itself, this rider provides a death benefit to heirs. With this rider, the insurance company guarantees to return the funds that have been invested to the contract beneficiary if the owner's death

occurs before the principal value of the annuity has been paid out. The benefit is equal to the premiums paid to the insurance company, less benefit payouts already made between the time the annuity begins and the time of the owner's death. Some insurers will also include interest earned while the contract was in force.

Of course, the longer the annuity contract has been in force and the more principal that has been paid out, the lower the benefit will be.

IMPAIRED RISK RIDER

With an impaired life annuity, the annuitant's insurance age is RATED to be OLDER than his or her chronological age. This is advantageous since the monthly income based on a rated or older age is higher than the income calculated using the person's actual age, given the same deposit amount. The insurance company pays a higher monthly income for an impaired life because the annuitant is not expected to live as long as the average person of the same chronological age. The shorter the life expectancy, the higher the monthly income.

The shorter the life expectancy, the higher the monthly income!

With this type of annuity, the annuitant provides the insurance company with an attending physician's statement and/or hospital records for review. A short time later, the insurance company will offer a "standard" rate if the medical history does not influence their mortality tables, or they will offer a "rated age" if they feel the medical history of the annuitant warrants a shorter life expectancy. The rated age would be older than the annuitant's actual age.

Medical conditions can include heart disease, cancer, stroke, alcoholism, leukemia, cirrhosis of the liver, high blood pressure, leukemia, and many other health-related conditions. Medical "conditions" may also include risk-related conditions such as: tobacco use, alcohol consumption, drug use; genetic factors, such as a family history of major disease; reckless driving, including citations and moving violations; dangerous hobbies, such as skydiving, and mountain climbing; dangerous occupations, such as roofing, police and firemen; and frequent travel to foreign countries.

ANNUITY WAIVERS

Annuity waivers contain a feature that triggers payments that are not subject to the usual surrender fees. There is no one trigger—waiver triggers vary from company to company.

Death Benefit Waiver — This waiver passes on the annuity to the beneficiary if the annuity holder dies before receiving payments from the annuity.

Nursing Home Waiver — If the owner or annuitant is confined to a licensed nursing home for more than a number of days specified in the contract and typically beginning after the first year of the annuity, no surrender charges will be deducted from the account value upon a full or partial surrender.

The nursing home waiver of withdrawal charge provision gives the owner of an annuity who is seriously disabled or needs to go to a nursing home before retirement, an opportunity to take payments that are not subject to the usual surrender fees. Serious health changes may trigger annuity payments even if the contract owner doesn't—or can't—retire. Situations that trigger the waiver allowing early annuity withdrawals vary from company to company. 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 the individual disabled if they're unable to work in **any** occupation, while another may require only the inability to work in the **current** occupation.

For instance, a surgeon may be deemed disabled by one insurer if he or she cannot operate because of, say, arthritis in the hands. Yet another company might decide that the doctor is not disabled because he can still see patients in an office setting, without performing surgery.

Terminal Illness Waiver — An annuity might also contain a provision that waives surrender charges if the annuity holder becomes terminally ill. In this case, the annuitant is allowed access to the funds when needed the most.

For the nursing home and terminal illness waivers, some contracts will stipulate that the waiver is available if the annuitant and/or their spouse is confined to a nursing home or becomes terminally ill.

Disability Waiver — Relatively few insurance companies offer the disability waiver, as the risk of disability is greater than the risk of death at all ages between 20 and 65.

Unemployment Waiver — Many companies have an Unemployment Waiver, an example of which is the following:

"If the owner is under the age of 65 and becomes unemployed any time after the annuity is issued, and remains unemployed for at least 30 consecutive days, the [annuity carrier] will not deduct a surrender charge from the account value upon a full or partial surrender while the owner is unemployed."

KEY POINTS TO PONDER

- The long-term care benefit rider is also referred to as the “accelerated death benefit.”
- The amount allowed when a long-term care rider is activated is a percentage of the policy face amount.
- The long-term care benefit rider and the LTC waiver of surrender charge have different features; the long-term care benefit rider provides more benefits.
- When the terminal illness rider is activated, the surrender charge is waived. However, the waiver requires confinement.
- The unemployment rider provides a certain percentage of monthly income, usually up to one year.
- Surrender charges are waived when the terminal illness rider is activated.
- The unemployment rider provides a certain percentage of monthly income for a limited time, typically for up to one year, in cases of unemployment.

CHAPTER 7 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. The long-term care benefit rider is also referred to as _____ rider.

   a) an elder care
   b) an impoverishment
   c) an accelerated death benefit
   d) a senior citizen

2. If an annuity has a long-term care rider, and that feature is activated, how is the payment amount determined?

   a) It will pay a percentage of the policy face amount.
   b) It will pay $10 per $100 of the contract value.
   c) It will pay $100 per $1,000 of the contract value.
   d) It will pay all charges incurred.

3. The long-term care benefit rider is the same as the long-term care waiver of surrender charge.

   a) TRUE
   b) FALSE

CHAPTER 8

LIVING AND DEATH BENEFIT RIDERS

Annuity contracts can be designed to guarantee the amount of income that can be withdrawn while the annuitant is still living. Because investors could benefit from this feature while still living, these benefits were given a new name in the industry—"living benefits."

Though the living and death benefit riders can provide many types of protection for contract owners and beneficiaries, they are optional add-ons to the annuity contract. The guarantees they offer come at a cost that should be weighed carefully to decide if the cost is justified. Not all riders are the same, so it's crucial to have an understanding of how they work, which type is right for which consumer, or even if one is appropriate at all.

1. **Living benefit riders** generally guarantee some sort of defined payout while the insured or annuitant is still alive;
2. **Death benefit riders** protect beneficiaries against declines in contract values because of market conditions.

BACKGROUND

The basic death benefit offered by a variable annuity is a guarantee that after the annuitant's death, the insurance company will pay the contract beneficiary at least the amount the contract owner paid into the annuity. Enhanced death benefits were introduced that offer monthly or annual "step-ups." If the policy has a monthly step-up, the insurance company takes a snapshot of the account value each month. The highest recorded value in the month becomes the death benefit amount when death occurs, even if the market value is currently less (minus any withdrawals taken, of course).

THE NEED FOR LIVING BENEFIT FEATURES

Historically, in **equity investing** upside potential has always been accompanied by downside risk. While an asset with equity features had considerable upside potential, the consumer shoulders the risks associated with investing in equities.

This risk of exposure was always very disheartening to investors because the pain of losing one dollar in the market is often more emotionally impacting to consumers than the happiness of gaining one dollar in the market.

The living benefit feature can take many forms.

- **GMDB** (Guaranteed Minimum Death Benefit) — Like GMWB, but guarantees withdrawals for life, not just until investment is recovered; also like GMIB, options may provide for a minimum rollup each year of income base amount prior to taking income withdrawals at retirement.
- **GMAB** (Guaranteed Minimum Accumulation Benefit) — Designed to protect against downside market risk (in accumulation or growth phase); guarantees a minimum contract value, regardless of investment performance. A GMAB could help ensure that when the contract owner is ready to collect retirement income payments, they would be based on a minimum payout base even if poor market performance lowers the value of the underlying investments.
- **GMIB** (Guaranteed Minimum Income Benefit) — Designed to provide a base amount of lifetime income; not tied to market performance. A GMIB could help ensure that when the contract owner is ready to collect retirement income payments, they would be based on a minimum payout base even if poor market performance lowers the value of the underlying investments.
- **GMWB** (Guaranteed Minimum Withdrawal Benefit) — Designed to protect against downside market risk; percentage of principal is withdrawn annually until principal is fully recouped. Adding a GMWB to a variable annuity contract could allows the contract owner to withdraw a fixed percentage (usually 5% to 7%) of the premiums paid until 100% of the premiums paid had been withdrawn, even if the contract's underlying investments were to lose money.

GUARANTEED MINIMUM DEATH BENEFITS

When guaranteed minimum death benefits first arrived on the scene, they were designed to guarantee an investor that "they couldn't lose money" in the market. They made this assertion by guaranteeing investors that, if they passed away at a time when the market was down, they would never get back less than their original

principal. This guarantee gave them “return OF” their money, and protected their heirs against market losses. Although the excitement of this protection against losing principal gave new life to the sales of variable annuities, innovation pressed on, and soon new improvements began reshaping the landscape of variable annuity death benefits.

The first enhancement was the introduction of death benefits that guaranteed to return more than the initial principal. These enhanced death benefits generally came in one of two forms. Charges are either based on "date of deposit" or "date of contract."

The first benefit to come along was a death benefit called GMDB—Guaranteed Minimum Death Benefits.

Next came the first real living benefit, GMAB—which stood for Guaranteed Minimum Accumulation Benefit. You could walk away with your GMAB value, regardless of the performance of the underlying investments.

Next came the second living benefit and first income benefit variable annuity, called GMIB. These annuities used a combination of a formula value and the guaranteed annuitization factors to guarantee a future income based on today’s deposit. The income amount could never be lower than the guarantee, but could be higher, depending on investment performance. However, once annuitized, there was no more contract liquidity.

Most recently, Guaranteed Minimum Withdrawal Benefits (GMWB) hit the scene as the popular form of income benefit variable annuity. They guarantee a minimum annuity withdrawal without annuitizing, thereby retaining the account value and the purported liquidity.

It’s important to realize that, even though Guaranteed Minimum Withdrawal Benefit riders may have become more popular, Guaranteed Minimum Income Benefits (GMIB) often guarantee a higher amount of annual income. That’s because of the benefits of annuitization. Therefore, the big decision between Guaranteed Minimum Income Benefits and Guaranteed Minimum Withdrawal Benefits boils down to whether or not the client is willing to trade some liquidity in exchange for potentially higher cash flow. As such, Guaranteed Minimum Income Benefits still have a prominent place in today’s retirement income planning, despite the fact that their popularity pales by comparison to Guaranteed Minimum Withdrawal Benefit products.

Living benefit variable annuities are not one-size-fits-all. They are not for everybody, and you must be careful not to put a disproportionate amount of your client’s assets

into Guaranteed Minimum Withdrawal Benefits. Living benefit variable annuities are complex products with many moving parts, and while they appear safe and guaranteed, they have many risks and disadvantages as well.

THE GUARANTEED MINIMUM DEATH BENEFIT RIDER

The Guaranteed Minimum Death Benefit rider guarantees that the death benefit protection of the contract won't lapse even if the cash surrender value is insufficient to cover monthly deduction charges. In short, the policy's death benefit is guaranteed, regardless of how the market is performing.

The Guaranteed Minimum Death Benefit rider supplies the ability to do something no other equity-based investment could do—provide upside market potential while protecting from the downside of adverse market performance. The Guaranteed Minimum Death Benefit rider guarantees that the beneficiary, as named in the contract, will receive a death benefit if the annuitant dies before the annuity begins paying benefits.

Variable annuity contracts have traditionally offered the guaranteed minimum death benefit during the accumulation period that is generally equal to the greater of the contract value at death, or premium payments minus any prior withdrawals. Enhanced Guaranteed Minimum Death Benefits have entered the arena as well.

Contract Anniversary Value or Ratchet — These are equal to the greater of the contract value at death, premium payments minus prior withdrawals, or the contract value on a specified prior date. The ratchet Guaranteed Minimum Death Benefit locks in the contract’s gains on each of the dates specified.

Initial Purchase Payment with Interest or Rising Floor — These are equal to the greater of the contract value at death, or premium payments minus prior withdrawals, increased annually at a specified rate of interest.

Enhanced Earnings Benefits — These provide a separate death benefit to help offset income taxes payable upon death on any gains in the contract. Beneficiaries receive not only the base death benefit amount, but also an additional amount that is usually equal to a percentage of the contract’s earnings at death.

GUARANTEED MINIMUM ACCUMULATION BENEFIT

During the growth phase, a Guaranteed Minimum Accumulation Benefit (GMAB) guarantees a minimum contract value—regardless of investment performance—after

a set period of time. The minimum is typically equal to or greater than the total premium and is payable as a single lump sum at the end of the accumulation period.

This concept provides consumers with protection against adverse market performance and, most of all, nobody has to die to receive the protection.

DISADVANTAGES OF THE GUARANTEED MINIMUM ACCUMULATION BENEFIT

It's important to understand some of the disadvantages and pitfalls that could affect consumers.

- Perhaps the biggest disadvantage is the expense. If the consumer is a long-term investor, has investment discipline, and is not planning to "take the money and run," the cost of the rider will slow their asset growth, which may not be in their best interests.
- Formula values often stop at the end of the stated minimum period. For example, a product may say that the benefit will be the initial deposit compounding annually at five percent (5%) for 10 years. If the investor intends to continue benefiting from Guaranteed Minimum Accumulation Benefit at the end of 10 years, they will probably need to start a new contract.
- The limitations over investment options may render the investment unsuitable for the investor. Most variable annuities with living benefits contain some form of investment limitation.

GUARANTEED MINIMUM INCOME BENEFIT

The Guaranteed Minimum Income Benefit (GMIB) goes one step further toward retaining upside market potential while eliminating downside market risk. In the income phase, the Guaranteed Minimum Income Benefit is designed to provide a base amount of lifetime income, regardless of market performance. This is generally provided with annuitization. Guaranteed Minimum Income Benefits may also provide for a guaranteed increase or "rollup" of the income base each year prior to the income phase beginning.

However, like all guarantees, it comes with strings attached, and the "fine print" needs to be examined.

DISADVANTAGES OF THE GUARANTEED MINIMUM INCOME BENEFIT

First, the annuitant must annuitize the contract to realize the benefits of the rider. If the market is up, and the annuity owner wants guaranteed income, they must annuitize. If the market is down and they want to take advantage of the higher "formula amount," they must annuitize.

If the market is down and an annuity owner chooses to terminate the annuity or exchange it for a new one, they forfeit the higher formula amount, and they will have paid the rider fees during the entire accumulation period without realizing any benefits from those charges.

Another disadvantage that goes hand-in-hand with annuitizing is that annuity owners lose flexibility after they annuitize. Annuitization is an event that typically cannot be adjusted or changed once it has been started.

A third disadvantage, which again goes hand-in-hand with annuitization, is that the contract owner loses the liquidity they had prior to annuitization.

With a Guaranteed Minimum Income Benefit, the insurance company contractually guarantees on annuitization payout factors many years in advance. In order to do that, the rates they use must be conservative rates.

GUARANTEED MINIMUM WITHDRAWAL BENEFIT

Another popular type of living benefit feature is the withdrawal benefit provision, also known as the Guaranteed Minimum Withdrawal Benefit (GMWB). This benefit is designed for investors who need monthly, quarterly, or annual income from their investment, and want a guarantee that they will never lose their principal, regardless of market performance.

The Guaranteed Minimum Withdrawal Benefit guarantees a certain percentage of the principal to be withdrawn annually until the entire amount is recouped, regardless of market performance—the insurance company guarantees that even if the market performs poorly, no invested funds will be lost. Furthermore, over the lifetime of the contract, an amount equal to the total principal, typically monthly, quarterly, or annually, can be withdrawn. Depending on the insurance company issuing the annuity, five percent to ten percent (5%-10%) per year can be withdrawn.

Additionally, because the income from the Guaranteed Minimum Withdrawal Benefit is provided by withdrawals instead of annuitization, this benefit has the additional advantage that, in addition to guaranteed lifetime income (with the opportunity for

increasing future withdrawals), Guaranteed Minimum Withdrawal Benefits also retain contract liquidity. If the owner has a financial crisis, they retain the ability to tap into the account values in the contract.

Because high volatility in annuity account values increases the cost of Guaranteed Minimum Withdrawal Benefits, these products also commonly include some sort of investment restriction to control account value volatility. Many companies do this by requiring that all funds be allocated to specified model portfolios. Even then, the more aggressive model portfolios are often unavailable to those who want to take advantage of the Guaranteed Minimum Withdrawal Benefit features.

These products also commonly contain incentives for delaying withdrawals. Some products reward consumers for waiting a specified number of years after the annuity is issued. Others reward consumers that are beyond a certain age when income begins. Then some products include both incentives.

Guaranteed Lifetime Withdrawal Benefit

The Guaranteed Lifetime Withdrawal Benefit (GLWB) is similar to the Guaranteed Minimum Withdrawal Benefit (GMWB), but it guarantees withdrawals for life, either regularly or occasionally, not just until the amount invested is recovered. The annuitant pays for the Guaranteed Lifetime Withdrawal Benefit with an extra percentage of fees of the total value of the annuity contract. The amount of money that is allowed to be withdrawn is a percentage of the total value of the annuity. Again, like the Guaranteed Minimum Income Benefit (GMIB), Guaranteed Lifetime Withdrawal Benefit options may provide for a minimum rollup each year of the income base amount prior to commencing income withdrawals at retirement.

Coordination of Living Benefits With Other Assets

Living benefit variable annuities must be coordinated with other financial assets. Don’t let living benefit variable annuities become your only tool to solve all of your client’s income problems. Continue to strategically position the living benefit variable annuities as a component of a well-coordinated, comprehensive retirement income plan.

Also remember that a key advantage to living benefit variable annuities is that they provide security for both the client and the broker in the event of an adverse market during a client’s retirement income phase. The client is protected from loss of income when adverse market conditions occur, and the broker is better insulated from future litigation by providing this extra layer of protection for clients.

KEY POINTS TO PONDER

- Living and death benefit riders are optional add-ons to an annuity contract for an additional fee.
- A living benefit rider guarantees a payout while the annuitant is still alive. A death benefit rider protects beneficiaries against a decline in the annuity's value.
- Not all riders are the same; it's important to understand how they work, and if their cost makes them worthwhile for the consumer.
- Guaranteed Minimum Death Benefits (GMDB) guarantee investors that, if they passed away at time when the market was down, they would never get back less than their original principal.
- During the growth phase, a Guaranteed Minimum Accumulation Benefit (GMAB) guarantees a minimum contract value, regardless of investment performance, after a set period of time.
- The Guaranteed Minimum Withdrawal Benefit (GMWB) guarantees a certain percentage of the principal to be withdrawn annually until the entire amount is recouped, regardless of market performance.
- A key advantage to living benefit variable annuities is that they provide security for both the client and broker in the event of an adverse market during a client's retirement income phase.

CHAPTER 8 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. What type of rider guarantees some sort of defined payout while the insured/annuitant is still alive?

   a) Living benefit riders
   b) Death benefit riders

2. What type of rider protects beneficiaries against declines in contract values due to market conditions?

   a) Living benefit riders
   b) Death benefit riders

3. Which of the living benefit riders guarantees that the death benefit protection of the contract won't lapse even if the cash surrender value is insufficient to cover monthly deduction charges?

   a) Guaranteed Minimum Accumulation Benefit (GMAB)
   b) Guaranteed Minimum Income Benefit (GMIB)
   c) Guaranteed Minimum Death Benefit (GMDB)
   d) Guaranteed Minimum Withdrawal Benefit (GMWB)

CHAPTER 9

SPECIAL CONSIDERATIONS — ANNUITY SALES TO SENIORS

As financial products become richer in benefits and attempt to address multiple needs within the same product, they can be more cost effective. As financial products become more multifaceted, they are also becoming more complex. This is not necessarily a criticism of the products, but rather a statement that they are becoming more difficult to understand.

As we age our ability to recognize, absorb and make sense of complex and abstract ideas diminishes. This is not a linear process and will proceed at different rates for different individuals. The concern with seniors, and I'll let the reader determine their own definition of 'senior,' is that they may have a difficult time understanding some of these more complex products. Regulators in several states have defined a senior as someone aged 65 or older, so this discussion will use that benchmark.

FILLING SENIOR NEEDS

Seniors need many of the same services and products that everyone else does. According to Senior Marketing Magazine, seniors do more and better research than most. They tend to be more careful about whom they do business with, and they want to know more about the individual with whom they are doing business.

Also, according to the Boomer Project founder, John Martin, tomorrow's seniors will be a more varied group than any other age group of people. This niche covers all races, socio-economic channels, political and religious persuasions, and of course genders.

Also, because of age, health plays a larger role in the buying process. Eyesight, hearing and engagement in discussion are first line indicators of the individual's competency to understanding the insurance advantages and disadvantages. Also, other health issues should be considered because of what they can do to the senior's outlook, emotional state and financial considerations. Adult children and grandchildren of seniors are also important considerations in the decision making process and should be addressed with the senior customer early on. Because

seniors are more than likely not to have a full time job, income you can't outlive is a larger consideration. However, asset liquidity for income is equally of concern. Balancing these two income needs is critical for their retirement security.

Diversity and flexibility of financial products can benefit the public. Unfortunately, however, diversity and flexibility can also lend themselves to abusive sales practices including fraud. All financial products are vulnerable to the contemptible tactics of the unscrupulous. The SEC held its first Senior Summit on how regulators and others can better coordinate efforts to protect older Americans on July 17, 2006. The SEC announced that the purpose of the Seniors Summit was "to examine investment fraud and abusive sales practices."[29]

The Seniors Summit released a new NASD Investor Education Foundation Fraud Study (http://www.nasd.com). Some of the study's key findings are the opposite of what one would expect. The study finds that "…investment fraud victims are more financially literate than non-victims." The study also finds that fraud victims, compared to the general population, are more educated, have high levels of income, and are more often married. The study further finds that fraud victims, compared to non-victims, are more optimistic, tend to have a personality that is more self-reliant and self-deterministic, and are more likely to rely on their own experience and knowledge to make financial decisions. The study concludes—contrary to common perception—that "traditional financial literacy education alone will not inoculate investors from being defrauded."

The study demonstrates an important need to rethink how we can teach investors to protect themselves against abusive sales practices and fraud. The study makes clear that factors other than the diversity and complexity of financial products contribute significantly to investment fraud. So, it's not enough simply to educate the public as to the characteristics and operation of financial products. Education must also address what the study calls the "psychological profile" of investors—the demographic and personality indicators.

This, however, is easier said than done. As the study recognizes, attempts to understand these psychological factors are still "early," and "social workers, researchers and law enforcement personnel" must do further work in order for us to have a fuller picture.

[29] www.sec.gov/news/press/2006/2006-109.htm

PRODUCT COMPLEXITY

As financial products become richer in benefits and attempt to address multiple needs within the same product, they can be more cost effective. As financial products become more multifaceted, they are also becoming more complex. This is not necessarily a criticism of the products, but rather a statement that they are becoming more difficult to understand.

As we age our ability to recognize, absorb and make sense of complex and abstract ideas diminishes. This is not a linear process and will proceed at different rates for different individuals. The concern with seniors, and I'll let the reader determine their own definition of 'senior', is that they may have a difficult time understanding some of these more complex products. Regulators in several states have defined a senior as someone aged 65 or older, so this discussion will use that benchmark.

The following section deals with recognizing diminished mental capacity and also with some of the unique ethical issues related to selling financial products to seniors.

"COMPETENT PARTIES" REQUIRE LEGAL CAPACITY

The issue of **legal capacity** often arises in cases involving senior consumers. Legal capacity is the term used to define someone who is able to understand and appreciate the consequences of his/her actions. A person who lacks legal capacity cannot, for example, enter into a contract, give a power of attorney, make a will, consent to medical treatment, or transfer property. The older we become, the more likely we are to develop a disability or a mental disease such as Alzheimer's disease or dementia.

If a producer sells an annuity to an individual who lacks legal capacity, it could be argued that the sale is inappropriate even if neither the producer nor the consumer was aware of the lack of mental capacity. Since basic contract law requires "competent parties," it could further be argued that the contract is not valid and binding on the incompetent individual.

The following section deals with recognizing diminished mental capacity and also with some of the unique ethical issues related to selling financial products to seniors.

DIMINISHED MENTAL CAPACITY

As part of this annuity training course we include information to help producers recognize when a prospective insured may lack the short-term memory or judgment

to knowingly purchase an annuity. To accomplish this goal, we will first distinguish between legal capacity (as described above) and diminished mental capacity.

One of the most troubling issues related to the sale of insurance products to seniors is the potential for **diminished mental capacity**. This is a difficult and sensitive issue that is becoming more common with the aging of our population. Diminished mental capacity does not necessarily mean that one does not have legal capacity, but it does indicate that they do not function as well as they previously did. Since each individual is unique and possesses varying degrees of decision-making capabilities at various stages of their lives, it is a considerable challenge to recognize diminished mental capacity in someone that you have only just met.

For the purposes of this course we will make the assumption that if someone lacks legal capacity, the agent should not need training to recognize lack of judgment and short-term memory in an individual so affected. Therefore we will focus on the recognition of diminished mental capacity which, while the lines are blurred, can be a precursor to lack of legal capacity.

Probability of Encountering Diminished Mental Capacity

A study published by the National Institute on Aging reveals that impaired cognitive ability (diminished mental capacity) affects approximately 20% of people aged 85 years or older.

Recognizing Diminished Mental Capacity

For an individual not formally trained in a mental health discipline, assessing diminished capacity is possible in some very clear cases; but in general, diagnosing mental and physical capacity is well beyond the professional training and expertise of the average insurance producer.

Several factors make assessing diminished mental capability difficult. Many individuals have occasional memory problems due to the natural aging process and take longer to make decisions.

Loss of memory and/or the onset of diminished mental capacity is usually a gradual process that can accelerate over time. It is entirely possible that a senior could make an insurance-related decision today when they appear to be cognitive and two or three years later (when a consumer complaint arises) be considered cognitively impaired.

First, it is always important that the marketing and provision of any financial services to senior citizens be done in an appropriate manner, and that the financial services and products be appropriate to these consumers with regard to age, risk tolerance, and understanding of the product being offered.

Diminished mental capacity may sometimes be difficult to identify, or may have pronounced symptoms.

Below is a listing of several indicators of diminished mental capacity that can alert the producer. Not all of these indicators will be observable in the context of a typical meeting between an insurance producer and consumer. Additionally, some of these indicators require a prior knowledge of the consumer in order to determine if there has been deterioration in a particular aspect of their behavior.

INDICATORS OF DIMINISHED MENTAL CAPACITY

- **Memory loss**: The senior is repeating questions, forgetting details, forgetting appointments, misplacing items or losing track of time.
- **Disorientation**: The senior is confused over time, place, or simple concepts.
- **Difficulty performing simple tasks**: The senior lacks the ability to remember the order of performance of the steps necessary to complete a simple task, such as tying their shoes.
- **Difficulty speaking**: The senior uses words that do not fit the context of their use.
- **Failure to recognize consequences**: The senior appears unable to appreciate the consequences of decisions.
- **Inconsistent decisions**: The senior makes decisions that are inconsistent with his or her current long-term goals or commitments.
- **Overly optimistic**: The senior seems overly optimistic.
- **Difficulty following simple directions**: The senior has difficulty with directions, particularly when the directions include multiple steps that must be performed in a certain order.
- **Deterioration of handwriting and signature**: The senior appears unable to accurately write the letters of the alphabet. They may write a C or an R backwards.
- **Drastic mood swings**: The senior may exhibit a swift change in mood within a short period of time with no obvious reason for the mood change.

- **Memory recall**: The senior does not remember or understand recently completed financial transactions.
- **Disorientation**: The senior appears to be disoriented with surroundings or social setting.
- **Lack of attention to personal hygiene**: The senior appears uncharacteristically unkempt.
- **Confusion as to date and time**: The senior may be confused as to the season of the year, the current month, the day of the week or the time of day.

ADDITIONAL INDICATORS

Below is an additional list of indicators that can best be judged by someone (such as a close relative or long time friend) with day-to-day exposure to the senior or someone who has known the senior for a long time, even if their exposure is infrequent.

- Changes in personality.
- Increased passivity.
- Poor judgment.
- Are they taking their medication when they should?
- Do they open their mail and pay their bills on time?

EXPLANATION OF INDICATORS

The Alzheimer’s Association has a listing of explanations for some of the indications of Alzheimer’s disease. While this information relates to the recognition of Alzheimer’s, it also puts these indicators into perspective. These can be of value to a producer in recognizing signs of short-term memory loss and/or lack of judgment.

Memory loss that affects job skills. It's normal to occasionally forget an item at the grocery store, deadline or colleague's name, but frequent forgetfulness or unexplainable confusion at home or in the workplace may signal something wrong.

Difficulty performing familiar tasks. Busy people get distracted from time to time. For example, you might leave something on the stove too long or not remember to serve part of a meal. People with Alzheimer's disease might prepare a meal and not only forget to serve it but also forget they made it.

Problems with language. Everyone has trouble finding the right word sometimes, but a person with Alzheimer's disease may forget simple words or substitute inappropriate words, making his or her sentences difficult to understand.

Disorientation of time and place. It's normal to momentarily forget the day of the week or what you need from the store. But people with Alzheimer's disease can become lost on their own street, not knowing where they are, how they got there or how to get back home.

Poor or decreased judgment. Choosing not to bring a sweater or coat along on a chilly night is a common mistake. A person with Alzheimer's, however, may dress inappropriately in more noticeable ways, wearing a bathrobe to the store or several blouses on a hot day.

Problems with abstract thinking. Balancing a checkbook can be challenging for many people, but for someone with Alzheimer's disease, recognizing numbers or performing basic calculation may be impossible.

Misplacing things. Everyone temporarily misplaces a wallet or keys from time to time. A person with Alzheimer's disease may put these and other items in inappropriate places—such as an iron in the freezer or a wristwatch in the sugar bowl—and then not recall how they got there.

Changes in mood or behavior. Everyone experiences a broad range of emotions—it's part of being human. People with Alzheimer's disease tend to exhibit more rapid mood swings for no apparent reason.

Changes in personality. People's personalities may change somewhat as they age. But a person with Alzheimer's can change dramatically, either suddenly or over a period of time. Someone who is generally easygoing may become angry, suspicious or fearful.

Loss of initiative. It's normal to tire of housework, business activities or social obligations, but most people retain or eventually regain their interest. The person with Alzheimer's disease may remain uninterested and uninvolved in many or all of his/her usual pursuits.

Unique Ethical and Compliance Issues Dealing with Seniors

In order to increase the likelihood of the senior making an informed decision there are several strategies that can be used. They are as follows.

- Try to arrange your meetings with seniors as early in the morning as convenient. When they are well rested they tend to make better decisions and have better cognitive function.
- Ask the senior to include a trusted family member to attend the meeting and assist with the decision making process.
- Ask the senior to repeat their understanding of your explanations of the different elements of the financial product being presented.
- Break the explanations and decisions down into smaller components and make sure the senior has a firm understanding at each juncture before proceeding.

INCLUDING A TRUSTED FAMILY MEMBER

In discussing the practice of asking a trusted family member to attend the meeting, it should be noted that privacy regulations may have an impact in this area.

Another complication regarding involving a trusted family member is that when senior financial abuse is discovered it is often a trusted family member who is the perpetrator.

SENIOR-RELATED PROFESSIONAL DESIGNATIONS

State insurance regulators are concerned about certain producers using “industry designations” that imply a heightened, unique or special qualification and/or specialized education that would make them better qualified to address the insurance needs of seniors.

Many of these “senior affinity” designations lack the underpinning of traditional designations, such as:

- Rigorous education and testing requirements for designation candidates;
- An enforceable code or canon of ethics; and
- Continuing education requirements to maintain the designation.

As a result of the proliferation of these designations, many states have adopted rules prohibiting the use of misleading senior designations and have provided a mechanism for creditable designation to be accredited.

The use of professional designations that imply expertise in providing investment advice to senior citizens, such as “Certified Senior Adviser,” “Certified Retirement

Financial Adviser," "Chartered Senior Financial Planner" and "Certified Financial Gerontologist" have come under scrutiny. Some claim that those designations involve little actual training regarding the needs of this vulnerable population. It appears that some of these "designations" were granted by for-profit entities, and serve more as marketing tools than as actual evidence of education or professional development. Most of the problems that have been reported against persons using these credentials have dealt with the sale of unsuitable annuities to senior citizens.[30]

While annuity suitability laws deal with the suitability of the sale of annuities to individuals of all ages, it is the senior citizen that is most often targeted for annuity sales. There are multiple reasons that senior consumers are the main focus of annuity sales efforts, but the main reason is that they have accumulated more funds than younger individuals and are often motivated to settle their financial matters as they enter their golden years. As our population in the United States ages, senior sales issues will become more prevalent and subject to additional regulations.

Several states have passed laws prohibiting the use of professional designations with the words "Senior," or "Retirement," or similar wording that implies special qualifications in the senior market, unless the entity offering the designation can demonstrate that successful candidates possess additional training or education.

It should be noted that there are a number of well-established industry designations with rigorous training and continuing education requirements that are viewed as valid designations by regulators and the industry as a whole.

SENIOR CITIZENS AND ANNUITY SCAMS

According to consumer advocacy group, Consumer Action, seniors make up 30% of fraud victims. The Certified Financial Planner Board of Standards found seniors who are victims of financial abuse lose an average of $140,500.[31]

Unfortunately, some unethical persons in our society prey on seniors due to their unique susceptibility. There have been reported cases of agents targeting elders who are terminally ill, convincing them to purchase an annuity that locks away their money for more than a decade. The annuity is set up so any money left in the annuity remains with the agent or the insurance company instead of the senior's beneficiaries, as mistakenly led to believe. When the senior passes away, the agent collects the death benefits. Other reports include mentally unstable seniors who are

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[30] Sandy Praeger, Kansas Insurance Commissioner and NAIC President Elect before the Senate Select Committee on Aging, Sept. 5, 2007

[31] Annuity.org, Annuity Scams, Oct. 17, 2019, https://www.annuity.org/annuities/scams/

made to feel their current investments are unsafe or won't last long enough, so they end up placing their faith and trust in an unscrupulous agent by giving them too much financial information and control over their assets.

NAIC CONSUMER ALERT

The NAIC recently published a Consumer Alert aimed at annuities and senior citizens warning them of inappropriate annuity sales practices.

"Senior Citizens Should Be Aware of Deceptive Sales Practices When Purchasing Annuities"

Annuity sales to senior citizens have significantly increased in recent years. However, as annuity sales have risen, so has a sense of confusion among consumers. This is due, in part, to questionable or deceptive sales practices employed by companies and producers looking to take advantage of uninformed consumers. It is extremely important, when considering whether or not to buy an annuity, to take the necessary precautions in order to make an informed decision that is best for the consumer.

UNDERSTAND THE PRODUCT YOU ARE BUYING

When it comes to annuities, inappropriate sales practices can occur in many ways and come from a variety of sources. Anyone can be a victim, but senior citizens remain a prime target. Following are a few suggestive guidelines in the publication.

- Always review the contract before you decide to buy an annuity. Terms and conditions of each annuity contract will vary.
- You should understand the long-term nature of your purchase. Be sure you plan to keep an annuity long enough so the charges don't take too much of the money you invest.
- Compare information for similar contracts from several companies. Comparing products may help you make a better decision.
- Ask your agent and/or the company for an explanation of anything you don't understand.
- Remember that the quality of service you can expect from the company and the agent should be an important factor in your decision.
- Verify that the company and agent are licensed. In order to sell insurance in your state, companies and agents must be licensed. To confirm the credibility of a company or agent, contact your state insurance department.

- Check the company's credit rating. Legitimate insurers have their "creditworthiness" rated by independent agencies such as Standard & Poor's, A.M. Best Co. or Moody's Investors Services. An "A+++" or "AAA" rating is a sign of a company's strong financial stability. You can easily check a company's rating online.
- The proof is in the paperwork. As you complete your research and decide to purchase a particular policy, it's important to keep detailed records. Get all rate quotes and key information in writing. Once you've made a purchase, keep a copy of all paperwork you complete and sign, as well as any correspondence, special offers and payment receipts.

AVOID BEING FOOLED BY DECEPTIVE SALES PRACTICES

Watch for the following red flags, which serve as warnings of possible deceptive sales practices.

- **High-pressure sales pitch**. If a particular group or producer has contacted you repeatedly, offering a "limited-time" deal that makes you uncomfortable or aggravated, trust your instincts and steer clear.
- **Quick-change tactics**. Skilled scam artists will try to prey on your "time fears." They may try to convince you to change coverage quickly without giving you the opportunity to do adequate research.
- **Unwilling or unable to prove credibility**. A licensed insurance producer will be more than willing to show adequate credentials.

Remember, if it seems too good to be true, it probably is!

RECENT ANNUITY SCAMS

Just as with any product being sold to the public, there are scams with annuities as well.

YOU WILL NEVER LOSE MONEY IN AN ANNUITY!

This statement can be true and it can be fraudulent.

TRUE: Fixed rate annuities do not expose the account value to risk; funds are deposits in an insurance company earning a fixed rate of interest.

FALSE: The account value in variable annuities is dependent on the performance of the chosen subaccounts

YOUR ANNUITY IS GOING TO EXPIRE!

Some insurance marketers will send out notices to annuity contract owners, or to individuals in a fishing expedition to see if they are, in fact, annuity owners. They will tell the consumer that their annuity is about to expire and they need to review the consumer's existing annuity to see if it still fits their needs. The real reason, of course, for this expedition is to sell something…a new product, a replacement contract, etc.,…most of which would NOT be beneficial to the consumer.

YOUR ANNUITY IS OUTDATED!

Those contract owners who have had an annuity for some time may be sold a line of goods that their annuity is outdated and needs to be "modernized." Though there are always new riders, amendments, waivers, being developed in the marketplace, annuities can never really become "outdated.

SENIOR SCAMMER IN ANNUITY FRAUD SCHEME

A man was arrested in Florida for scamming nine seniors between the ages of 80 and 94 out of over $650,000 in an annuity fraud scheme. The man was charged with multiple felony counts including exploitation of the elderly, grand theft and perpetrating a scheme to defraud.

Florida's Chief Financial Officer stated: *"Specifically targeting seniors to defraud them out of their life savings will not be tolerated in Florida. These seniors worked hard their entire lives and trusted this individual with the dollars they responsibly set aside for their retirement years. My office will continue to track down these scammers and protect your hard-earned dollars."*

After the Florida Department of Financial Services' Division of Consumer Services received a complaint from a victim, an investigation by the Division of Insurance Fraud alleged that over a period of seven years Victor Edwin Ruser, Sr., age 59, aggressively "churned" annuities of his senior clientele by talking them into terminating their policies and then investing them into new accounts. This caused large surrender charge penalties for the investors involved while Ruser earned commissions on each transaction.

Ruser invested his clients' money into TruVest, LLC and Alliance Life and Investments Company accounts, which he solely owned and operated. Further investigation revealed no insurance or investment vehicle within these companies and all monies had been converted to Ruser's personal use.

Ruser was booked into County Jail on and is being held with bond set at $1.3 million. If convicted, he could face up to 205 years in prison.[32]

UNSUITABLE RECOMMENDATIONS TO A SENIOR

The following is taken from the disciplinary files of FINRA.

A registered representative unethically exploited a senior customer for financial reasons, made an unsuitable recommendation to the customer, and inappropriately maintained in his files two forms that the customer signed in blank.

Peter Orlando violated FINRA Rule 2010 by using his position as a registered representative to exploit unethically a senior customer, age 81, to become her attorney-in-fact, executor, and beneficiary of her bank account and primary beneficiary of her will. In doing so, Orlando also allegedly circumvented the policies of his firm, which prohibited its registered representatives from being named as a beneficiary of a financial account or acting in a position of trust for anyone who was not a family member. Consequently, Orlando failed to observe high standards of commercial honor and just and equitable principles of trade and violated FINRA Rule 2010.

Orlando also violated FINRA Rules 2111 and 2010 by recommending that the customer surrender a variable annuity that included a guaranteed minimum income benefit; causing the consumer to incur unnecessary sales and withdrawal charges and ignoring the customer's need for income. Orlando's recommendations were unsuitable for the customer in light of her financial profile and, thereby, Orlando violated FINRA Rules 2111 and 2010.

Finally, Orlando violated FINRA Rule 2010 by unethically maintaining in his files two forms that the customer signed in blank. Orlando was barred from associating with any FINRA member in any capacity for using his position to obtain control of his customer's assets, money, and property unethically.

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[32] myfloridacfo.com/PressRelease, Florida CFO Jeff Atwater Announces Arrest of Senior Scammer in Annuity Fraud Scheme, 11/15/2012, https://www.myfloridacfo.com/sitePages/newsroom/pressRelease.aspx?id=3979

As a result, Orlando was barred from associating with any FINRA member in any capacity for this misconduct. Orlando was also ordered that he pay his customer $4,000 in restitution, plus prejudgment interest; pay hearing costs of $7,693.86; and appeal costs of $1,630.20.[33]

[33] FINRA.org, Complaint No. 2014043863001, March 16, 2020, Department of Enforcement vs. Peter Orlando, Taunton, MA, https://www.finra.org/sites/default/files/2020-03/NAC_201404863001_Orlando_031620.pdf

KEY POINTS TO PONDER

- Memory loss, disorientation, being overly optimistic, and lack of attention to personal hygiene are all indicators of diminished capacity.
- When dealing with a senior, it is recommended to ask the senior to repeat their understanding of your explanations of the different elements of the financial product being presented.
- State law prohibits the use of misleading senior designations.
- Seniors make up 30% of fraud victims, with an average loss of $140,500.
- Consumers must be aware of red flags that would indicate possible deceptive sales practices, such as high-pressure sales pitches, quick-change tactics, and a sales person who is unwilling or unable to prove their credibility.

CHAPTER 9 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. Which of the following would NOT be an indicator of diminished capacity?

   a) Memory loss
   b) Disorientation
   c) Overly optimistic
   d) Attention to personal hygiene

2. There are several strategies that can increase the likelihood of a senior consumer making an informed decision. Which of the following would NOT be applicable?

   a) Arrange your meetings with seniors as early in the morning as convenient.
   b) Don't' ask the consumer to repeat their understanding of your presentation, assume the senior understands so as not to embarrass them.
   c) Ask the senior to include a trusted family member to the meeting.
   d) Break the explanations and decisions down into smaller components and make sure the senior has a firm understanding at each juncture before proceeding.

3. State insurance departments have indicated that insurance producers may use terminology that makes consumers understand that you are specialized in senior education, even if you’re not so accredited.

   a) TRUE
   b) FALSE

CHAPTER 10

ANNUITY TAXATION

The premium is the contract owner's original contribution, or principal contribution. Since they have already paid taxes on it, it never again will be subject to taxation. This assumes that they haven't purchased an annuity as part of a qualified retirement program such as an IRA, 401(k), TSA or 457 plan.

The funds put into an annuity will earn interest or receive dividend income or capital gain distributions. Unlike money in a savings account, mutual fund, or certificate of deposit these "earnings" 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 eventually collects taxes on those earnings, however. When money is withdrawn from the annuity, earnings are withdrawn first. The earnings are subject to ordinary income taxes in the year in which they are withdrawn. (Keep in mind that capital gain distributions in a mutual fund are taxed at capital gains rates.)

And, of course, there are penalties for premature distributions. If annuity owners under the age of 59½ withdraw their earnings, not only are their earnings taxed at ordinary income tax rates, the IRS charges an additional 10% penalty on the earnings that are taxed.

TAX-FREE GROWTH

There are very few places where one can experience tax-free growth within the current tax structure in the United States. Some municipal bonds are exempt from federal and state income taxes, and the interest paid by these instruments is priced with this advantage in mind. As with tax deferral, the value of tax-free growth will vary from one taxpayer to another based on a number of factors.

Another place where tax-free growth can be obtained is through the use of a Roth IRA. The Roth IRA is also an exception among qualified retirement plans in that it is exempt from the required minimum distribution requirements. The intent here is not to write a section on the Roth IRA, but to point out that many annuities can be placed within a Roth IRA and most annuity issuers offer an annuity that can be used inside of a Roth.

ANNUITY TAXATION BASICS

Generally it is recommended that you never have three parties to the contract. In other words, a different individual is named as owner, annuitant, and beneficiary. If you do have three different parties, you raise the possibility of all kinds of nasty tax results, including inadvertent gifts to payees from the owner. Generally, however, taxes are only paid when interest is withdrawn.

- Just like the IRA, the 10% excise tax penalty exists.
- The exclusion ratio allows clients to receive income partially income tax-free.
- Section 1035(a) exchanges are a way to move annuity money income tax-free.

THE ANNUITANT OR OWNER

While the owner and the annuitant may be the same individual, the annuitant is the individual upon whose life expectancy payouts are determined. The payouts are made to the owner unless he or she directs the company to pay them to the annuitant.

Payments may be made as one lump sum, random withdrawals, or as a series of scheduled payouts over a specific period or a lifetime. Payments are taxed in various ways.

If the payment is made as a lump sum, income taxes will be due on the difference between the amount paid into that annuity and its value when it is paid out. Just like a traditional IRA, taxable withdrawals made prior to the annuitant's age 59½ are generally subject to a 10% early withdrawal penalty.

When the contract is annuitized (a series of scheduled payouts over a specific period or a lifetime), part of each payment is considered a return of previously taxed principal (i.e., the premium paid in) and part earnings. The taxpayer will owe income taxes on the part of the payment that is considered earnings. The amount of each annuity payment that won't be taxed is computed using an exclusion ratio, which is generally determined by dividing the premium paid into the contract by the total amount expected to be distributed during the payout period.

Example:

Assume Dick, age 62, has a fixed annuity into which he paid $100,000 of premium and will receive payouts of $700 a month for the rest of his life. According to

IRS life expectancy tables, Dick will receive those payments for 22.5 years, so the contract's value is $189,000 (12 x $700 x 22.5). The exclusion ratio is 52.9% ($100,000/$189,500). So, out of the $8,400 the annuity pays each year, Dick may exclude $4,444 from income.

DISTRIBUTIONS MADE TO THE BENEFICIARY

If distribution payments had begun and the annuitant dies, the benefits would generally have to be distributed to the beneficiary at least as rapidly as through the method in effect at the time of the annuitant's death. Taxation will continue to apply to those proceeds based on the beneficiary's ordinary income tax bracket using the same exclusion ratio that was in effect when the annuitant was alive.

EXCLUSION RATIO

The exclusion ratio is the percentage of an investor's return that is not subject to taxes. Any return above the exclusion ratio is subject to taxation. The exclusion ratio applies to nonqualified annuities.

The exclusion ratio applies to immediate annuities purchased with at least a portion of after-tax money—the ratio is determined from the amount of after-tax money used to purchase the annuity.

Once the expected return has been calculated, the exclusion ratio is calculated by solving the fraction in which the cost basis in the annuity is the numerator and the expected return is the denominator. Note this exclusion ratio is recalculated each year (until the entire cost basis is returned). The Tax Equity and Fiscal Responsibility Act of 1983 (TEFRA) requires the annuity company to calculate the portion of each annuity withdrawal or payment that is attributable to the cost basis and gain and report it to the recipient on a Form 1099, a copy of which goes to the IRS.

Example:

Assume an annuity was purchased one year ago for $80,000. It is now worth $88,000. The total of all premiums paid in the contract equal $80,000. Further assume that the contract owner wants to annuitize and elects the settlement option of a five-year period certain (60 months) where monthly payments will be $1,667 a month. The expected return is $100,000 ($1,667 multiplied by 60 months).

Therefore, 80% of all payments to the contract owner are income tax free ($80,000 of $100,000 = 80%). For annuities using a life contingency, calculate life expectancy using government tables to determine the expected return.

Effective with all annuities starting dates after December 31, 1986, payments become fully taxable after the owner recovers the total of all premiums paid into the contract (determined by adding all dollars excluded from taxes). After the contract owner has lived beyond his life expectancy (as calculated when payments began), payments then become fully taxable.

- **Exclusion Ratio is recalculated each year until the entire cost basis is returned**
- **Expires when all the principal has been paid out**

UNDER-DISTRIBUTION PENALTY

Failure to make the required minimum distribution by the end of the calendar year results in a penalty equal to 50% of the amount of the distribution. In addition, ordinary income taxes are due on the entire amount.

PENALTY TAX ON PREMATURE DISTRIBUTIONS

Withdrawals made from all annuities (nonqualified and qualified) prior to the contract owner attaining age 59½ are called premature distributions. All annuities are subject to this IRS penalty regardless of annuity type. Not only are the earnings taxed at ordinary income tax rates, an additional penalty of 10% is charged on the earnings withdrawn.

However there are no penalties on distributions if any of the following conditions apply:

- If they are made after the taxpayer reaches age 59½;
- If they are made on or after the death of the owner of the annuity—If the owner is not an individual then the death of the primary annuitant;
- If the taxpayer became disabled;
- If they are a part of a series of substantially equal periodic payments (not less than annually) for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer and his or her designated beneficiary;
- If they are made under an annuity contract that is purchased with a single premium when the annuity starting date is no later than a year from purchase

of the annuity and substantially equal periodic payments are made, not less frequently than annually, during the annuity period;

- If they are made under certain annuities issued in connection with structured settlement agreements; or
- Annuitization (for the owner's life or life expectancy).

Unreimbursed medical expenses — Even if younger than age 59½, an owner does not have to pay the 10% tax on amounts withdrawn that are not more than the amount paid for unreimbursed medical expenses during the year of the withdrawal, minus a certain percentage of the adjusted gross income for the year of the withdrawal (7.5% AGI; after 2012, 10% if under age 65). The annuitant may only take into account unreimbursed medical expenses that would be included in figuring a deduction for medical expenses on Schedule A, Form 1040. Deductions do not have to be itemized to take advantage of this exception to the 10% additional tax.

Medical insurance costs — Even if younger than age 59½, an owner may not have to pay the 10% tax on amounts withdrawn during the year that are not more than the amount paid during the year for medical insurance for themselves, their spouse, and their dependents. Owners will not have to pay the tax on these amounts if all four of the following conditions apply.

- They lost their jobs.
- They received unemployment compensation paid under any federal or state law for 12 consecutive weeks.
- They made the withdrawals during either the year they received the unemployment compensation or the following year.
- They made the withdrawals no later than 60 days after they became re-employed.

Disability — If the owner becomes disabled before reaching age 59½, any amounts withdrawn because of disability are not subject to the 10% additional tax. The owner is considered disabled if they furnish proof that they are unable to do any substantial, gainful activity because of their physical or mental condition. A physician must determine that the condition can be expected to result in death or to be of long, continued, and indefinite duration.

Death — If the owner dies before reaching 59½, the assets in the annuity can be distributed to beneficiaries or to the owner's estate without having to pay the 10% additional tax.

Higher education expenses — Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution. In addition, if the individual is at least a half-time student, room and board expenses are qualified higher education expenses.

Even if the owner has not yet reached 59½, if he or she paid expenses for higher education during the year, part (or all) of any withdrawal may not be subject to the 10% tax on early withdrawals. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses for the year for education furnished at an eligible educational institution. The education must be for the owner, a spouse, or the children or grandchildren of the owner or the spouse.

When determining the amount of the withdrawal that is not subject to the 10% tax, include qualified higher education expenses paid with any of the following types of funds:

- An individual's earnings;
- A loan;
- A gift;
- An inheritance given to either the student or the individual making the withdrawal;
- Personal savings (including savings from a qualified state tuition program).

Do not include expenses paid with any of the following funds:

- Tax-free distributions from an education IRA;
- Tax-free scholarships, such as a Pell grant;
- Tax-free employer-provided educational assistance;
- Any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible educational institution.

An **eligible educational institution** is any college, university, vocational school, or other post-secondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit making) post-secondary institutions. The educational institution should be able to tell the annuitant if it is an eligible educational institution.

First-time home buyer — To qualify for penalty-free withdrawal treatment as a first-time homebuyer distribution, a distribution must meet the following requirements:

- It must be used to pay qualified acquisition costs before the close of the 120th day after the day they received it; or
- It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer who is any of the following:
    - The annuity owner;
    - The annuity owner's spouse;
    - The child of the annuity owner or his or her spouse;
    - The grandchild of the annuity owner or his or her spouse; or
    - The parent or other ancestor of the annuity owner or his or her spouse.

When added to all the prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000. If both husband and wife are first—time homebuyers, they may each withdraw up to $10,000, penalty free, for the purchase of a first home.

Qualified acquisition costs include the costs of buying, building, or rebuilding a home and any usual or reasonable settlement, financing, or other closing costs.

A first-time homebuyer is, generally, any individual (and his or her spouse, if married) who had no present ownership interest in a main home during the two-year period ending on the date the individual acquires the main home to which these rules apply.

The date of acquisition is the date that the first-time homebuyer enters into a binding contract to buy the main home to which these rules apply or the building or rebuilding of the main home to which these rules apply begins.

Exceptions to the Premature Distribution Penalty Tax:

- **Unreimbursed medical expenses**
- **Medical insurance**
- **Disability**
- **Death**
- **Higher education expenses**

- **First home purchase**

AVOIDING THE PREMATURE WITHDRAWAL PENALTY

If an annuity owner adheres strictly to one of three withdrawal methods of which the IRS approves, he or she may make withdrawals prior to age 59½ and avoid the premature distribution penalty tax.

The annuitant may receive distributions that are part of a series of substantially equal payments over the annuitant's lifetime (or life expectancy), or over the lifetimes (or joint life expectancies) of the annuitant and the beneficiary, without having to pay the 10% additional tax, even if such distributions are received before the annuitant reaches age 59½.

The annuitant must use an IRS-approved distribution method and at least one distribution must be received annually for this exception to apply.

The payments under this exception must continue for at least five years, or until the annuitant reaches age 59½, whichever is the longer period. This five-year rule does not apply if a change from an approved distribution method is made because of the death or disability of the annuity owner.

For example, if the annuitant received a lump sum distribution of the balance in an annuity before the end of the required period for the annuity distributions, and they did not receive it because of disability, the annuitant would be subject to the 10% additional tax. The tax would apply to the lump sum distribution and all previous distributions made under the exception rule.

There are two other IRS approved distribution methods. They are generally referred to as the **fixed amortization method** and the **fixed annuitization method**. The details of all three IRS-approved methods are presented below.

The required minimum distribution method — The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

The fixed amortization method — The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

The fixed annuitization method — The annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in the uniform lifetime table and using the chosen interest rate. Under this method, the account balance, the annuity factor, the chosen interest rate and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

One-time change to required minimum distribution method — An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years and the change in method will not be treated as a modification within the meaning of §72(t)(4). Once a change is made under this paragraph, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be considered a modification.[34]

Remember: These two methods are complex and require the assistance of a tax professional.

TAX-DEFERRED TRADING CORRIDOR

Variable annuities have another great benefit with regard to taxation deferment. They enable the investor to move money from one subaccount to another without incurring any taxes on the transaction. An aggressive portfolio could be toned down, and a conservative portfolio could be invested more aggressively, all without tax consequences at the time the funds were switched. These tax benefits of variable annuities attracted a lot of investment dollars, but they still shared all of the downside market risks of mutual funds.

[34] irs.gov/pub/irs-drop/rr-02-62

TAXATION OF DEATH BENEFIT PROCEEDS

Amounts withdrawn because of the death of the annuity owner or annuitant are taxed as a full withdrawal. The gain over the investment in the annuity is taxed as ordinary income. Proceeds that are withdrawn under a payout option are taxed the same way as annuity payouts.

TAXATION OF VARIABLE ANNUITIES

Variable annuities are generally a tax-favored investment product when purchased by an individual on a nonqualified basis. The growth is tax-deferred and therefore not subject to current income taxation. Variable annuities purchased as part of a qualified retirement plan such as an IRA, 401(k), TSA - 403(b), or deferred compensation plan - 457 are taxed under the special tax provisions governing that qualified retirement plan.

If the owner of the annuity is a person, not a business entity, then increases in the value of the annuity contract are not taxed until a distribution occurs by withdrawing all or part of the annuity value or selecting an annuity payout option. In addition, if one assigns or pledges any portion of the value of their annuity contract, it will generally be treated as a distribution. The taxable portion of a distribution is taxed as ordinary income.

If the contract is owned by other than a natural person, such as a business entity, then the increase in value over the investment in the annuity must be included as income during the year.

STATE PREMIUM TAXES ON VARIABLE ANNUITIES

Some states impose a **state premium tax** against either the accumulated value of the variable annuity or the purchase payments. Companies deduct these taxes as incurred according to state regulations. State tax laws change, so check with the company issuing your variable annuity contract for the most current tax status.

DISASTER TAX RELIEF

Recent legislation has enacted special rules that provide for tax-favored withdrawals, repayments, and loans from certain retirement plans (including qualified annuities) for taxpayers who suffered economic losses as a result of certain major disasters that occurred in 2018, 2019, and early 2020.

A qualified disaster distribution is any distribution received from an eligible retirement plan, which includes annuities, under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A qualified disaster distribution is any distribution received from an eligible retirement plan if all of the following conditions apply and an economic loss was sustained because of the disaster.

- If the distribution was made:
    - After August 22, 2017, and before January 1, 2019, for Hurricane Harvey or Tropical Storm Harvey;
    - After September 3, 2017, and before January 1, 2019, for Hurricane Irma;
    - After September 15, 2017, and before January 1, 2019, for Hurricane Maria; or
    - After October 7, 2017, and before January 1, 2019, for the California wildfire disasters.
- If the main home was located in a disaster area listed below on the date or any date in the period shown for that area:
    - August 23, 2017, for Hurricane Harvey and Tropical Storm Harvey disaster area. For this purpose, that area includes the states of Texas and Louisiana;
    - September 4, 2017, for the Hurricane Irma disaster area. For this purpose, that are includes the states of Florida, Georgia, and South Carolina; the territories of Puerto Rico and the U.S. Virgin Islands; and the Seminole Tribe of Florida;
    - September 16, 2017, for the Hurricane Maria disasters. For this purpose, that area includes the territories of Puerto Rico and the U.S. Virgin Islands; or
    - October 8, 2017, to December 31, 2017, the California wildfire disaster area. For this purpose, that area includes the state of California.

Qualified disaster distributions — The definition of a qualified disaster distribution has been expanded to include distributions made from an eligible retirement plan to an individual whose main home was in a qualified disaster area at any time during that disaster's incident period and who sustained an economic loss because of the disaster.

Qualified disaster area — Any area with respect to which a major disaster was declared after 2017 by the President under Section 401 of the Robert T. Stafford

Disaster Relief and Emergency Assistance Act, except the California wildfire disaster area defined in the Bipartisan Budget Act of 2018.

Incident period — The period specified by the Federal Emergency Management Agency (FEMA) as the period during which the disaster occurred, but not including any dates before 2018.

Qualified disaster distribution — A qualified disaster distribution for 2018 and 2019 disasters are those distributions from an eligible retirement plan:

- Made on or after the first day of the incident period of a qualified disaster and before June 27, 2020;
- Made to an individual whose main home at any time during the incident period of such qualified disaster was in the qualified disaster area; and
- That individual sustained an economic loss because of the disaster.

Economic loss — Qualified disaster distributions are permitted without regard to need or the actual amount of economic loss. Examples of economic loss include, but aren't limited to:

- Loss, damage to, or destruction of real or personal property from fire, flooding, looting, vandalism, theft, wind, or other cause;
- Loss related to displacement from the home; or
- Loss of livelihood due to temporary or permanent layoffs.

DISTRIBUTION LIMIT FOR 2018 AND 2019 DISASTER DISTRIBUTIONS

The total of qualified disaster distributions from all plans is limited to $100,000 per disaster for certain major disasters that occurred in 2018, 2019, and early 2020. If distributions are taken from more than one type of plan, such as a 401(k) plan and an IRA, and the total amount of distributions exceeds $100,000 for a single disaster, the $100,000 limit can be allocated among the plans by any reasonable method chosen. A reduction or offset of account balance in an eligible retirement plan in order to repay a plan loan can also be designated as a qualified disaster distribution.

TAXATION OF QUALIFIED DISASTER DISTRIBUTIONS

Qualified disaster distributions are included in income in equal amounts over three years. However, if elected, the entire distribution in income in the year it was received can be included.

Qualified disaster distributions aren't subject to the 10% additional tax on early distributions from qualified retirement plans (including IRAs). Also, if you are receiving substantially equal periodic payments from a qualified retirement plan, the receipt of a qualified disaster distribution from that plan won't be treated as a change in those substantially equal payments merely because of the qualified disaster distribution. However, any distributions received in excess of the $100,000 qualified disaster distribution limit may be subject to the additional tax on early distributions.[35]

TAXATION OF ANNUITY TRANSFERS

Section 1035(a) of the Internal Revenue Code provides a no-risk feature by allowing annuity owners to transfer funds from one annuity to another, thereby keeping the investment monies tax-free before payout begins.

The contract owner may elect to perform any of the following:

- Assign the old annuity contract (if premiums are nonqualified) to the new insurance company;
- Exchange the entire annuity (cannot transfer some of the money):
    - If there are loans outstanding, repay loans before exchanging;
- Parties designated in the old contract as owner, annuitant and/or beneficiary should again be designated in the new contract; and
- Customers should consult with their tax advisor before the exchange.

Title 26, Subtitle A, Chapter 1, Sub-chapter O, Part III, Section 1035 states that "no gain or no loss shall be recognized on the exchange" of a life insurance policy for another life insurance policy or endowment or annuity policy...an endowment for another endowment with a maturity no later than the maturity date of the endowment being replaced...an annuity policy for another annuity policy.

This benefit comes with some important considerations, however.

- The tax code says that the old insurance contract must be *exchanged* for a new contract—you cannot receive a check and apply the proceeds to the purchase of anew insurance or annuity contract.
- The tax code also says you can make a tax-free exchange from: (1) a life insurance contract to another life insurance contract or an annuity contract or

[35] irs.gov, *Qualified Disaster Distributions*

(2) from one annuity contract to another annuity contract. You cannot, however, exchange an annuity contract for a life insurance contract.

EXCEPTIONS TO TAXATION OF TRANSFERS

The following are exceptions to the taxation of annuity earnings when ownership is transferred:

- Transfers of ownership incident to divorce (qualified domestic court order);
- Transfers of ownership between spouses;
- Transfers of ownership between an individual and their grantor trust.

Note that such transfers should be reviewed carefully.

REASONS FOR MAKING A SECTION 1035 EXCHANGE

There are various reasons why a variable annuity contract holder may want to exchange an existing variable annuity contract.

- Many annuity contracts now offer premium—sometimes called bonus—credits toward the value of the contract, of a specified percentage ranging from one to five percent (1%-5%) for each purchase payment made.
- Also, in recent years, there have been new developments in annuity features, especially in variable annuities, that are valid reasons to consider an exchange. The number of investment options has increased. Less expensive variable annuity contracts have been created. Death and living benefits have been enhanced. Also, with the growth in the stock market in the 1990s, many insurance contract holders have wanted to take part in that growth. These are all valid reasons for considering exchanging one insurance contract for another.

REASONS FOR NOT MAKING A SECTION 1035 EXCHANGE

The exchange or replacement of insurance or annuity contracts may not be a good idea, for a variety of reasons.

- Bonus (or "premium") payments made are usually offset by the insurance company’s adding other charges.

- Other contract provisions, like surrender charges, eventually expire with an existing contract. However, new charges may be imposed with a new contract or may increase the period of time for which the surrender charge applies.
- Higher charges, such as annual fees, may be encountered for the new contract.
- Maybe those costly new features of the new contract are not really needed.
- In many instances, the producer/broker is getting paid a higher commission for a variable annuity than he or she would for the sale of another securities product, such as a stock, bond, or mutual fund.[36]

BUYER BEWARE

An annuity should only be exchanged if the contract owner believes, after knowing all the facts, that it is better for them and not just better for the person who is trying to sell the new contract.

Much of the sales growth of variable annuities in recent years has been from Section 1035 Exchanges. Given the fact that some variable annuity enhancements have made variable annuities more attractive, the consumer still needs to be sure that the exchange meets their objectives and is beneficial.

PRODUCER RESPONSIBILITIES WHEN CONDUCTING AN EXCHANGE

Brokers or insurance agents recommending the exchange of an annuity contract must confer to the consumer important facts about the pros and cons of the exchange. A broker or insurance agent is permitted to recommend such an exchange to **ONLY** if it is in the consumer's best interest and only after evaluating the consumer's personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed contract. This "suitability" obligation is based on FINRA rules.

Most states and brokerage firms require forms to reflect customer acknowledgment of a replacement transaction. These forms are to be signed by the annuity contract owner and the salesperson. These forms may provide a comparison of the features and costs of an existing contract to a proposed contract, and point out what the consumer needs to focus on when considering the exchange.

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[36] FINRA, Investor Alert, Should You Exchange Your Variable Annuity? https://www.finra.org/investors/alerts/should-you-exchange-your-variable-annuity

LIFE INSURANCE TO ANNUITY TRANSFER

Donald purchased a life insurance policy 20 years ago with a death benefit of $100,000, a premium of $1,000 a year, and has accumulated a cash value of $75,000. Donald is now retiring and has adequate life insurance protection provided by another life insurance policy.

Donald doesn't need any income at this time, but has decided to purchase an annuity that is paying a six percent (6%) guaranteed rate of interest. The cash value of the life insurance policy is $75,000, the premiums paid total $20,000, and if Donald surrenders his policy, the gain of $55,000 would be subject to taxation.

The solution is to execute a 1035 Exchange. Donald will fill out a 1035 Exchange form which directs the life insurance company to send the $55,000 cash value **directly** to the insurance company issuing his annuity policy. Donald never takes constructive receipt of the money (he never has it in his hands or bank account), so he is not taxed. The cost basis of the life insurance policy (his original $20,000 investment) is also transferred into the new annuity contract for future tax calculations.

ANNUITY TO ANNUITY TRANSFER

1035 exchanges between annuities function in the same fashion as when transferring from a life insurance policy to an annuity. The most common reason to execute a 1035 exchange between annuities is to earn a higher rate of interest. It is suggested that before a contract owner considers such a 1035 exchange, that he or she discover if any penalties or surrender charges would be imposed before exchanging an existing annuity contract.

PARTIAL 1035 EXCHANGE

In an outcome that surprised some, the Tax Court held that a proper Section 1035 exchange had taken place when an annuity holder transferred only a portion of the funds in one annuity to a second newly-issued annuity. This approval of a partial exchange may increase the planning opportunities typically associated with Section 1035 tax-free exchanges.

In its opinion, the court examined the regulations for Section 1035, legislative history, and a case dealing with the exchange of Section 403(b) annuities and concluded that there is no requirement stipulating that the entire annuity contract must be exchanged. The court's opinion stated that the only requirements under the

applicable regulations are that the contracts be of the same type (e.g., an annuity for an annuity) and that the obligee under the two contracts be the same person.

ONE-FOR-TWO 1035 EXCHANGE

Under Section 1035, exchanges are not actually tax-free, but tax-deferred. The investment in the original contract is carried over to the new contract, so the gain is deferred until payments begin or a withdrawal from the new policy is made.

An owner of a deferred annuity requested a ruling on whether the exchange of one annuity contract for two annuity contracts would qualify as a Section 1035 exchange. The two replacement contracts were to be issued by the same insurance company that issued the original annuity contract. The exchange would not have resulted in a change of owner or annuitant.

The reason this became an issue is because the language of Section 1035 says that an exchange can be made of "an annuity contract for an annuity contract," which might lead some to believe it means that one contract may be exchanged for only one new contract.

In the case at hand, one of the new annuities was to be a variable annuity. The other was to have a guaranteed minimum income feature so that regardless of the performance of the underlying investments of the annuity, a minimum amount will be paid out each month.

In its ruling, the IRS pointed out that if two or more annuities were purchased with the same consideration, the annuities would be treated as one annuity contract for income tax purposes. The IRS also said that Section 1035 is similar to Section 1031, which governs exchanges of other types of property such as real estate. Under Section 1031, one piece of property may be exchanged for multiple pieces of property on a tax-deferred basis, such as one piece of real estate for two or more.

Therefore, the IRS concluded that the proposed exchange would qualify for Section 1035 treatment, and that the two new annuity contracts would be treated as one contract for income tax purposes. Finally, the IRS ruled that any transfer of funds between the two new annuities would not be treated as a taxable distribution from the annuity. (The ruling for this is Private Letter Ruling 200243047.)

CONSUMER CONSIDERATIONS WITH A 1035 EXCHANGE

Following is a list of questions for consumers when they are considering a 1035 Exchange.

- What is the total cost to me of this exchange?
- What does the change in the surrender period or other terms mean for me?
- What are the new features being offered? Why do I need or want those features?
- Are those features worth the increase cost?
- Will you be paid a commission for the exchange and, if so, how much is it?

TAXATION OF RETIREMENT PLAN ROLLOVERS

Most people spend their lives working and putting as much money as they can aside for their retirement years. What are the options when a person leaves the workforce and enters that realm? If they have an employer sponsored retirement plan, a very viable option is to take advantage of the many benefits of rolling a 401(k), IRA, or 403(b) funds into an annuity—tax-free!

Normally, 401(k) funds are taxed as ordinary income when withdrawn. However, the law allows direct rollovers on a tax-free basis, if the rollover is conducted appropriately.

Most pre-retirement payments received from a retirement plan or IRA can be rolled over by depositing the payment in another retirement plan or IRA within the allowed timeframe.

There is no requirement to leave the funds inside the IRA annuity for any particular timeframe before income payouts can begin; payments can begin immediately if desired. Payout amounts will depend on the account value, the annuitant's age, gender, and payout option chosen.

If the employee (i.e., contract owner) receives the distribution check directly from the employer, the recipient must finalize the rollover to an annuity within 60 days. Otherwise, the distribution will be considered taxable. There are several ways to complete the rollover.

Direct rollover — If getting a distribution from a retirement plan, the plan administrator can make the payment directly to another retirement plan or IRA. The administrator may issue the distribution in the form of a check made payable to the new account. No taxes will be withheld from the transfer amount.

Trustee-to-trustee transfer — If getting a distribution from an IRA, the financial institution holding the IRA can make the payment directly from the IRA to another IRA or to a retirement plan. No taxes will be withheld from the transfer amount.

60-day rollover — If distribution from an IRA or a retirement plan is paid directly to the investor, all or a portion of the funds in the IRA or retirement plan must be made within 60 days. Taxes will be withheld from a distribution from a retirement plan, so other funds will have to be used to roll over the full amount of the distribution.

IRA ONE-ROLLOVER-PER-YEAR RULE

Generally, only one rollover can be made from the same IRA within a one-year period. Since 2015, only one rollover from an IRA to another (or the same) IRA in any 12-month period can be made, regardless of the number of IRAs owned. The one-per year limit does not apply to:

- Rollovers from traditional IRAs to Roth IRAs (conversions);
- Trustee-to-trustee transfers to another IRA;
- IRA-to-plan rollovers;
- Plan-to-IRA rollovers;
- Plan-to-plan rollovers.

The gross income of any previously untaxed amounts distributed from an IRA if made in an IRA-to-IRA rollover (other than a rollover from a traditional IRA to a Roth IRA) in the preceding 12 months must be included. (The 10% early withdrawal tax on the amount included in gross income may apply.)

Tax consequences:

If you receive a distribution from an IRA of previously untaxed amounts, you must include the amounts in gross income if you made an IRA-to-IRA rollover in the preceding 12 months, and you may be subject to the 10% early withdrawal tax on the amounts included in gross income.

DISTRIBUTION ROLLOVERS

You can roll over all or part of any distribution from an IRA except a required minimum distribution or a distribution of excess contributions and related earnings.

You can roll over all or part of any distribution of a retirement plan account except:

- Required minimum distributions;
- Loans treated as a distribution;
- Hardship distributions
- Distributions of excess contributions and related earnings;
- A distribution that is one of a series of substantially equal payments;
- Withdrawals electing out of automatic contribution arrangements;
- Distributions to pay for accident, health or life insurance;
- Dividends on employer securities; or
- S corporation allocations treated as deemed distributions.

Distributions that can be rolled over are called “eligible rollover distributions.” Of course, to get a distribution from a retirement plan, you have to meet the plan’s conditions for a distribution, such as termination of employment.

ROLLOVER CHART

Funds can be rolled over into almost any type of retirement plan or IRA (see the chart below for options).

		Roll To							
		Roth IRA	**Traditional IRA**	**SIMPLE IRA**	**SEP-IRA**	**457(b)**	**Qualified Plan**[1] (pre-tax)	**403(b)** (pre-tax)	**Designated Roth Account** (401(k), 403(b), or 457(b))
Roll From	Roll From								
	Roth IRA	Yes[2]	No	No	No	No	No	No	No
	Traditional IRA	Yes[3]	Yes[2]	Yes[2,7], after 2 years	Yes2	Yes4	Yes	Yes	No
	SIMPLE IRA	Yes[3], after 2 years	Yes[2], after 2 years	Yes[2]	Yes[2], after 2 years	Yes[4], after 2 years	Yes, after 2 years	Yes, after 2 years	No
	SEP-IRA	Yes[3]	Yes[2]	Yes[2, 7], after 2 years	Yes[2]	Yes[4]	Yes	Yes	No
	457(b)	Yes[3]	Yes	Yes[7], after 2 years	Yes	Yes	Yes	Yes	Yes[3,5]
	Qualified Plan1 (pre-tax)	Yes[3]	Yes	Yes[7], after 2 years	Yes	Yes[4]	Yes	Yes	Yes[3,5]
	403(b)	Yes[3]	Yes	Yes[7], after 2 years	Yes	Yes[4]	Yes	Yes	Yes[3,5]
	Designated Roth Account (401(k), 403(b) or 457(b))	Yes	No	No	No	No	No	No	Yes[6]

Table 10.1[37]

[1]Qualified plans include, for example, profit sharing, 401(k), money purchase, and defined benefit plans. [2]Only one rollover in any 12-month period. [3]Must include in income. [4]Must have separate accounts. [5]Must be an in-plan rollover. [6]Any nontaxable amounts distributed must be rolled over by direct trustee-to-trustee transfer. [7]Applies to rollover contributions after December 18, 2015.

[37] irs.gov/pub/irs-tege/rollover_chart.pdf

WILL TAXES BE WITHHELD FROM A DISTRIBUTION?

If you have elected a direct rollover, in the case of a distribution from a retirement plan, or you have not elected out of withholding in the case of a distribution from an IRA, the plan administrator or IRA trustee will withhold taxes from the distribution. If the distribution is rolled over later, within 60 days, other funds must be used to make up for the amount withheld.

Example:

Laurie, age 42, received a $10,000 eligible rollover distribution from her 401(k) plan. Her employer withheld $2,000 from her distribution.

If Laurie later decides to roll over the $8,000, but not the $2,000 withheld, she will report $2,000 as taxable income, $8,000 as a nontaxable rollover, and $2,000 as taxes paid. Laurie must also pay the 10% additional tax on early distributions on the $2,000 unless she qualifies for an exception.

If Laurie decides to roll over the full $10,000, she must contribution $2,000 from other sources. Laurie will report $10,000 as a nontaxable rollover and $2,000 as taxes paid.

If you roll over the full amount of any eligible rollover distribution received (the actual amount received plus the 20% that was withheld minus $10,000 in the example above):

- The entire distribution would be tax-free, and
- The 10% additional tax on early distributions would be avoided.

The plan administrator must provide a written explanation of rollover options for the distribution, including the consumer's right to have the distribution transferred directly to another retirement plan or to an IRA.

If you're no longer employed by the employer maintaining the retirement plan and the plan account is between $1,000 and $5,000, the plan administrator may deposit the money into an IRA in your name if you don't elect to receive the money or roll it over. If your plan account is $1,000 or less, the plan administrator may pay it to you, less, in most cases, 20% income tax withholding, without your consent. You can still roll over the distribution within 60 days.

If you receive an eligible rollover distribution from your plan of $200 or more, the plan administrator must provide a notice informing you of your rights to roll over or transfer the distribution and must facilitate a direct transfer to another plan or IRA.[38]

TAXATION OF NONQUALIFIED ANNUITIES

A nonqualified annuity is an annuity that is inside of a qualified retirement plan such as an IRA or 401(k).

The money deposited into an annuity (contributions) is referred to as a premium, and in a nonqualified plan the premium becomes the income tax cost basis for determining which portion of the annuity is subject to taxation upon withdrawal. Premiums contributed to a nonqualified annuity are made with after-tax money and are not deducted from taxable income. Since income taxes have already been paid on the premiums contributed to a nonqualified annuity, those premium dollars are never again subject to income taxation.

The money deposited into an annuity may earn interest, receive dividend income, or earn capital gain distributions. For the purposes of this discussion on annuity taxation we will collectively refer to these various increases in the value of an annuity as earnings. These earnings—unlike earnings in a savings account, mutual fund, or certificate of deposit—are not taxed in the year in which they are earned. Thus the earnings continue to grow and compound, tax-deferred, until withdrawn.

Since the growth that occurs within a nonqualified annuity is tax-deferred, it is not added to the annuity owner's income until it is withdrawn from the annuity. This gives rise to a potential benefit of an annuity to certain individuals.

When funds are paid out from a nonqualified variable annuity, only the net gain (the investment earnings) is taxable. The funds contributed aren't taxed because the contributions were made with after-tax dollars. As a result, a portion of each payment received is treated as principal (a return of the contract investment) for tax purposes.

The nontaxable portion of each payment is determined by the ratio of investment in the contract to the account balance. More precisely, the tax-free and taxable portions of annuity payments are figured using a special computation explained in IRS Publication 575 (detailed later). The insurance company reports the total annual

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[38] IRS, Rollovers of Retirement Plan and IRA Distributions, Feb. 2020, https://www.irs.gov/retirement-plans/plan-participant-employee/rollovers-of-retirement-plan-and-ira-distributions

payouts to the recipient and to the IRS on Form 1099-R. Usually, the form will also show the taxable amount.

WHEN AN ANNUITY IS OWNED BY A NON-NATURAL PERSON

A non-natural person could be a corporation, partnership, or trust. In most cases, an annuity owned by a non-natural person is not treated as annuity for federal income tax purposes; therefore, earnings on annuities owned by non-natural persons are taxed in the year received (or credited to the annuity) as ordinary income.

Exceptions — There are several exceptions to an annuity owned by a non-natural person not being taxed as an annuity.

- Immediate annuities are exempt from this rule.
- An annuity contract will be treated as owned by a natural person if the owner is a trust or other entity that holds the annuity as an agent for a natural person.

This exception does not apply in the case of an employer who is the owner of an annuity contract under a nonqualified deferred compensation arrangement for its employees. If owner of an annuity is a grantor trust, the death of grantor triggers mandatory distribution. This does not apply to annuities issued prior to January 19, 1985.

TAXATION OF WITHDRAWALS FROM NONQUALIFIED ANNUITIES

TOTAL SURRENDER

When a nonqualified annuity contract is fully surrendered in a single lump sum transaction, the owner must pay income tax on all of the earnings in the contract. Earnings are determined as the excess amount received over the amount of premiums paid, calculated upon surrender.

PARTIAL WITHDRAWAL

Partial withdrawals from a nonqualified annuity that are not payments under an annuity settlement option are taxed on a last-in, first-out (LIFO) basis. This is actually called the earnings-first method of gain recognition. In order words, withdrawals from an annuity are made earnings first, and the owner is taxed on the payments until all of the earnings have been distributed. This assumes the cost basis is the last portion withdrawn from the annuity.

There is an exception to the earnings first rule for contributions made to annuity contracts prior to 8/14/82 (also called a pre-TEFRA annuity). These contributions are distributed on a first-in, first-out (FIFO) basis and the owner is not taxed until such contributions are fully recovered.

If a pre-TEFRA annuity is exchanged for another annuity, it keeps pre-TEFRA tax treatment described above.

TAXATION OF ANNUITIZATION OF NONQUALIFIED ANNUITIES

When a nonqualified annuity is annuitized, a portion of each annuity payment represents a return of cost basis and is not taxed, and the remainder of each annuity payment is considered earnings and taxed as ordinary income. The taxable and non-taxable portions of the annuity payments are determined using the exclusion ratio.

The exclusion ratio for an annuity is the ratio the cost basis (premiums paid) in the contract bears to the expected return under the contract. Calculating the expected return involves actuarial assumptions if the annuitization is based on a single or joint life.

Once the total cost basis in the nonqualified annuity is recovered using the exclusion ratio, the remaining annuity payments are fully taxable. If the owner dies before the total cost basis is recovered, and annuity payments cease as a result of his death, the unrecovered cost basis is allowed as a deduction to the owner on their final income tax return.

TAXATION UPON DEATH OF THE OWNER PRIOR TO ANNUITIZATION

Unlike most other assets, annuities do not receive a step-up in cost basis at the death of the owner/annuitant; therefore the beneficiary will owe ordinary income tax on all of the earnings in the annuity.

If the beneficiary annuitizes the contract, a portion of each annuity payment will be considered a return of cost basis and not taxable. Determining the taxable portion of each annuity payment was discussed above.

Note: Variable annuities issued prior to October 21, 1979 do receive a step-up in cost basis for income tax purposes, and no income tax is payable on the earnings accumulated during the life of the owner when received by the beneficiary.

ANNUITANT-OWNED ANNUITIES

In most cases the owner of the annuity is also the annuitant. The examples in this section will assume the annuitant and the owner are the same person.

Spousal Beneficiary — A surviving spouse beneficiary of an annuity can be treated as the new owner. This will allow the surviving spouse of the owner/annuitant to step into the shoes of the deceased owner/annuitant and continue to experience tax-deferred growth until he or she dies.

Non-Spousal Beneficiary — Unlike a spouse, non-spouse beneficiaries of nonqualified annuities can't assume ownership, but must take the benefits within five years. If the annuity is distributed within five years, taxation of earnings is calculated the same as lump sum (if the annuity is distributed in a lump sum) or as partial withdrawals (if the annuity is distributed in more than one distribution).

A non-spousal beneficiary does have the option of annuitizing the annuity; however, they must annuitize the contract within 60 days of the owner/annuitant's death. In addition the annuity payments must begin within one year after the owner/annuitant dies. This option allows the non-spousal beneficiary to spread the taxation of earnings out over a potentially longer period. If the annuitization option is chosen by the non-spouse beneficiary, taxation of earnings is calculated using the exclusion ratio.

Note: If an annuity contract has joint owners, the distribution at death rules are applied upon the first death.

IF OWNER DIES AFTER ANNUITIZATION

If the annuitant dies after annuitization, any remaining payments must be paid out at least as rapidly as under the annuity payout option in effect at the time of the owner's death. Taxability of earnings will be determined using the exclusion ratio described earlier.

TAXATION OF OWNERSHIP CHANGES

If the owner(s) add or delete a joint owner, it will be considered a transfer and will trigger taxation of earnings attributable to the transfer of ownership. These transfers of ownership can take the following forms:

- Adding, changing or deleting a joint owner;
- Transfer of ownership to another person or entity;

- Collateral assignment of the annuity if the annuity was issued after August 13, 1982. If the entire annuity is pledged as collateral, all future earnings within the annuity will be taxed as partial withdrawals in the year credited.

In addition to taxation of earnings there may be a 10% penalty (assessed on the earnings only) if the owner is younger than 59½.

Depending on the nature and amount of the transfer gifts taxes may also be payable.

INTERACTION WITH SOCIAL SECURITY BENEFITS

The tax-deferred earnings that occur within an annuity do not count toward income thresholds for the purpose of determining if the annuity owner pays federal income taxes on their Social Security benefits.

This will be a benefit to an individual (versus other investments without this benefit) if the earnings within the annuity would cause the individual to pay taxes on their Social Security benefits had they occurred outside of an annuity.

To determine if this will accrue as a benefit to an individual, the agent will need to know the individual's overall tax situation in considerable detail.

Since the growth that occurs within a nonqualified annuity is tax-deferred, it is not added to the annuity owner's income until it is withdrawn from the annuity. This gives rise to a potential benefit of an annuity to certain individuals.

Taxation of Social Security benefits is tied to exceeding certain income thresholds, which vary depending on tax filing status. Below is a brief discussion of how to determine if an individual (or couple) will pay taxes on part of their Social Security benefits.

This usually happens only if there is other substantial income (such as wages, self-employment, interest, dividends and other taxable income that must be reported on the tax return) in addition to the benefits.

First determine "combined income" as follows.

Adjusted gross income + Nontaxable interest + ½ of the Social Security benefits = "Combined Income"

***Note**: Non-taxable income would also include income from municipal bonds.*

Then check the "combined income" against the threshold below to see how much (if any) of Social Security benefits are taxable.

- If you file a federal tax return as an individual/head of household and your combined income is:
  - between $25,000 and $34,000, you may have to pay income tax on up to 50% of your benefits; or if
  - more than $34,000, up to 85% of your benefits may be taxable.
- If you file a joint return, and you and your spouse have a combined income that is
  - between $32,000 and $44,000, you may have to pay income tax on up to 50% of your benefits; or if
  - more than $44,000, up to 85% of your benefits may be taxable.
- If you are married and file a separate tax return, you probably will pay taxes on your benefits.

Another important consideration is the taxing of Social Security benefits if the recipient's other income is too high. Individuals with earned income of more than $200,000 ($250,000 for married couples filing jointly) pay an additional 0.9% in Medicare taxes.

SOCIAL SECURITY AND COST OF LIVING ADJUSTMENTS

The **cost of living adjustment** (COLA) is an adjustment made to Social Security benefits in order to modify beneficiary income in an effort to counteract the effects of inflation. Cost of living adjustments were first paid in 1975 as a result of a 1972 law.

The cost of goods and services in the third quarter consumer price index is compared with the previous year's third quarter. The Social Security Administration calculates cost of living adjustments by comparing the average index value of the Consumer Price Index for July, August and September of each year with data from the same period in the prior year. It then adjusts all retirement benefits upward by the resulting percentage increase, if there is one.

This is the way the cost of living adjustment has been calculated since its integration into the Social Security program. Meanwhile, however, lawmakers have been pushing for a different kind of inflation measure to be used to determine Social

Security cost of living adjustments. As policymakers debate ways to reduce the federal budget deficit, several proposals have included a change to the way that inflation is calculated in Social Security. A new cost of living measure (chained-CPI), which grows more slowly than the current calculation (CPI-W), would reduce spending on Social Security as well as other federally administered programs such as Supplementary Security Income (SSI) and pensions for veterans.

The chained Consumer Price Index measures living costs differently because it assumes that when prices for one thing go up, people will settle for cheaper substitutes. Cost of living increases would be lower using this method rather than with the traditional CPI calculation method. Estimates show that under the chained CPI, cost of living adjustments would average .3 percentage (0.3%) points below the CPI method. That works out to three dollars ($3) less on every $1,000. May not sound like much but, over time, it can certainly make a dent in a person's retirement check. For now, the method for cost of living adjustment computation remains the same, with the standard Consumer Price Index method.

Beneficiaries are notified every year when the cost of living adjustment is announced. If benefits are received by check, beneficiaries will receive a notice explaining the cost of living adjustment with the check. If benefits are received by direct deposit, beneficiaries will be notified in advance. If there is an increase, it must be rounded to the nearest tenth of one percent. If there is no increase, or if the rounded increase is zero, there is no cost of living adjustment.

The cost of living adjustment increases a person's Social Security retirement benefit by approximately the product of the cost of living adjustment and the benefit amount. The exact computation, however, is more complex.

The table below shows estimated future cost of living adjustments and estimated future percentage increases in the national Average Wage Index (AWI). The Average Wage Index is used to index an individual's earnings through age 60 in the benefit calculation formula, and the cost of living adjustment is used to increase benefits annually. The cost of living adjustment shown for a year is effective for December of that year, but is payable in January of the following year.

PROJECTED COLA AND AWI INCREASES

TRUSTEES REPORT — INTERMEDIATE ASSUMPTIONS		
PROJECTED COLAS & AWI INCREASES		
CALENDAR YEAR	COLA*	INCREASE IN AWI*
2021	2.6%	4.2%
2022	2.6%	3.9%
2023	2.6%	3.7%
2024	2.6%	3.8%
2025	2.6%	3.8%
2026 and later	2.6%	3.8%
*Average increase		

Table 10.2[39]

Assuming a hypothetical 2.8% cost of living adjustment, if a beneficiary's monthly benefit is $2,000, the following would apply.

- In 10 years, their monthly benefit will be $2,636.
- In 20 years, their monthly benefit will be $3,474.
- In 30 years, their monthly benefit will be $4,580.

When Social Security computes a beneficiary's retirement benefit, they use the national Average Wage Index series to index that person's earnings. This indexation ensures that a worker's future benefits reflect the general rise in the standard of living that occurred during his or her working lifetime.

Each Social Security benefit is based on the worker's primary insurance amount. The Primary Insurance Amount (PIA) in turn is directly related to the primary beneficiary's earnings through a specific benefit formula. It is the Primary Insurance Amount that is increased by the cost of living adjustment, with the result adjusted to the next lower dime.

[39] SSA Trustees Report 2017

Example:

If the initial Primary Insurance Amount is $1,275.50 and is increased by a 2.8% cost of living adjustment, the new Primary Insurance Amount would be $1,311.21 (after adjustment to the next lower dime).

The cost of living adjustment shown for a year is effective for December of that year, but is payable in January of the following year.

TAXATION OF QUALIFIED ANNUITIES

A qualified annuity is an annuity that is within a qualified retirement plan. Once an annuity has been placed within a qualified retirement plan it is taxed identically to any other qualified account such as an IRA, 401(k), profit sharing plan or other tax-deferred retirement account. Another way to explain it is that the annuity ceases to be taxed as an annuity and assumes all of the tax characteristics of the qualified retirement plan it is placed within.

CONTRIBUTIONS TO QUALIFIED ANNUITIES

Almost all contributions to qualified annuities are made with before-tax dollars. Since, by definition, a qualified annuity is within a qualified retirement plan, all contributions are deducted from taxable income. In employer provided qualified retirement plans, these contributions are actually excluded from taxable income for federal income tax purposes.

All growth or earnings that occur within a qualified annuity is tax-deferred and will not be taxed until withdrawn. When withdrawn all taxable amounts from a qualified annuity will be taxed as ordinary income.

Note: Due to the tax nature of a Roth IRA, qualified annuities within a Roth do not result in a deduction from taxable income for contributions. The Roth IRA is also an exception to most of the other tax aspects related to other qualified retirement plans.

THE ROTH IRA IS AN EXCEPTION

Due to the tax nature of a Roth IRA, qualified annuities within a Roth do not result in a deduction from taxable income for contributions. The Roth IRA is also an exception to most of the other tax aspects related to other qualified retirement plans.

AGGREGATE ANNUITY RULE

There is an aggregation rule that requires all annuity contracts issued by the same company, to the same owner, in the same calendar year be treated as one annuity contract for purposes of determining the taxable portion of any distributions.

The following are exceptions to the aggregation rule:

- Immediate annuities;
- Annuities that are annuitized;
- Distributions required at the death of the annuity owner;
- Annuities issued prior to October 21, 1988.

Note: If an annuity issued prior to October 21, 1988 is exchanged or transferred to another annuity, the new annuity is subject to aggregation.

While the actual taxation of aggregate annuity policies varies by insurance company, the IRS rules are clear. Section 72 of the internal revenue code governs the income tax treatment of amounts received under an annuity contract. For purpose of IRS rules, “gross income” includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity. “Gross income” does not, however, include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date).

Amounts received under an annuity contract are includible in income except to the extent that they represent a return of the investment in the contract (i.e., premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract that was excludable from gross income. The 1988 Act added the Section (11) the aggregation rule, under which all deferred annuity contracts issued by the same insurance company to the same policyholder during any calendar year are treated as one annuity contract. This aggregation rule prevents the marketing of multiple deferred annuities, referred to as serial contracts, designed to avoid the income-out-first rules of Section 72(e).

More insurance companies are coming into compliance with this rule. However, their interpretation can vary greatly. Some companies will use a calendar year and some companies will use a 12-month period. Depending upon the policy if the account is owner driven or annuitant driven, you can have multiple ownerships.

For example, using an owner driven policy, the husband owns one policy, the wife owns one policy and a family trust owns one policy. This would allow three policies that would not be affected by the aggregate rule.

Using the split annuity concept, some consumers will choose a fixed and an indexed annuity. Many strategies involve a five-year single premium immediate annuity and two deferred annuities, one to be annuitized after the fifth year and one to be annuitized after the tenth year.[40]

26 U.S. CODE §72 – ANNUITIES

Not all sections of §72 are presented below—only those that are pertinent to our discussion.

Section (a)(1) Income Inclusion. Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

AMOUNTS NOT RECEIVED AS ANNUITIES

Section 72(e) Amounts not received as annuities. (1)(A) In general, this subsection shall apply to any amount which (i) is received under an annuity, endowment, or life insurance contract, and (ii) is not received as an annuity, if no provision of this subtitle (other than this subsection) applies with respect to such amount.

(1)(B) For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2)(A)(B) If received before the annuity starting date (i) shall be included in gross income to the extent allocable to income on the contract, and (ii) shall not be included in gross income to the extent allocable to the investment in the contract.

ALLOCATION OF AMOUNTS TO INCOME AND INVESTMENT

(3)(A) **Allocation of amounts to income**. Any amount to which this subsection applies shall be treated as allocable to income on the contract to the extent that such

[40] United Brokerage Services, http://www.unitedbrokerageservices.com/uploads/6/1/5/8/61586067/aggregate_annuity_rules.pdf

amount does not exceed the excess (if any) of (i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received, over (ii) the investment in the contract at such time.

(3)(B) **Allocation to investment**. Any amount to which this subsection applies shall be treated as allocable to investment in the contract to the extent that such amount is not allocated to income under subparagraph (A).

Special Rules for Application

(4)(A) **Special rules for application of paragraph (2)(B)**. For purposes of paragraph (2)(B) loans treated as distributions, if during any taxable year, an individual (i) receives (directly or indirectly) any amount as a loan under any contract to which this subsection applies, or (ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract, such amount or portion shall be treated as received under the contract as an amount not received as an annuity. The preceding sentence shall not apply for purposes of determining investment in the contract, except that the investment in the contract shall be increased by any amount included in gross income by reason of the amount treated as received under the preceding sentence.

Treatment of Policyholder Dividends

(4)(B) **Treatment of policyholder dividends**. Any amount described in paragraph (1)(B) shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

Treatment of Transfers Without Adequate Consideration

(4)(C) **Treatment of transfers without adequate consideration**. (i) In general if an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of (I) the cash surrender value of such contract at the time of transfer, over (II) the investment in such contract at such time, under the contract as an amount not received as an annuity.

(4)(C)(ii) **Exception for certain transfers between spouses or former spouses**. Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

(4)(C)(iii) **Adjustment to investment in contract of transferee**. If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract of the transferee in such contract shall be increased by the amount so included.

Retention of Existing Rules in Certain Cases

(5)(A) In general, in any case to which this paragraph applies (i) paragraphs (2)(B) and (4)(A) shall not apply, and (ii) if paragraph (2)(A) does not apply, the amount shall be included in gross income, but only to the extent it exceeds the investment in the contract.

(5)(B) **Existing contracts**. This paragraph shall apply to contracts entered into before August 14, 1982. Any amount allocable to investment in the contract after August 13, 1982, shall be treated as from a contract entered into after such date.

(5)(C) **Certain life insurance and endowment contracts**. Except as provided in paragraph (10) and except to the extent prescribed by the Secretary by regulations, this paragraph shall apply to any amount not received as an annuity which is received under a life insurance or endowment contract.

(5)(D) **Contracts under qualified plans**. Except as provided in paragraph (8), this paragraph shall apply to any amount received (i) from a trust described in section 401(a) which is exempt from tax under section 501(a), (ii) from a contract (I) purchased by a trust described in clause (i), (II) purchased as part of a plan described in section 403(a), (III) described in section 403(b), or (IV) provided for employees of a life insurance company under a plan described in section 818(a)(3), or (iii) from an individual retirement account or an individual retirement annuity. Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

Refunds, Surrenders, Redemptions, and Maturities

(E) **Full refunds, surrenders, redemptions, and maturities**. This paragraph shall apply to (i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and (ii) any amount received under a contract on its complete surrender, redemption, or maturity. In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

INVESTMENT IN THE CONTRACT

(6) **Investment in the contract**. For purposes of this subsection, the investment in the contract as of any date is (A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

TAX TREATMENT OF DISTRIBUTIONS FROM PENSION AND ANNUITY PLANS

IRS publications discuss the tax treatment of distributions received from pension and annuity plans and also show how to report the income on the individual's federal income tax return. The two most common publications are Publication 575, Pension and Annuity Income, and Publication 939, General Rule. Before diving into the intricacies of the Publication and taxation general rules, there are some terms that are used in the publication that you need to be familiar with.

DEFINITIONS USED IN THE CONTEXT OF PUBLICATION 575

Pension – A pension is generally a series of definitely determinable payments made to you after you retire from work. Pension payments are made regularly and are based on such factors as years of service and prior compensation.

Annuity – An annuity is a series of payments under a contract made at regular intervals over a period of more than 1 full year. They can be either fixed (under which you receive a definite amount) or variable (not fixed). You can buy the contract alone or with the help of your employer.

Qualified employee plan – A qualified employee plan is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify). To determine whether your plan is a qualified plan, check with your employer or the plan administrator.

Qualified employee annuity – A qualified employee annuity is a retirement annuity purchased by an employer for an employee under a plan that meets Internal Revenue Code requirements.

Designated Roth account – A designated Roth account is a separate account created under a qualified Roth contribution program to which participants may elect to have part or all of their elective deferrals to a 401(k), 403(b), or 457(b) plan designated as Roth contributions. Elective deferrals that are designated as Roth contributions are included in your income. However, qualified distributions (explained later) aren't included in your income. You should check with your plan administrator to determine if your plan will accept designated Roth contributions.

Tax-sheltered annuity plan – A tax-sheltered annuity plan (often referred to as a 403(b) plan or a tax-deferred annuity plan) is a retirement plan for employees of public schools and certain tax-exempt organizations. Generally, a tax-sheltered annuity plan provides retirement benefits by purchasing annuity contracts for its participants.

Types of pensions and annuities – Pensions and annuities include the following types.

Fixed-period annuities – You receive definite amounts at regular intervals for a specified length of time.

Annuities for a single life – You receive definite amounts at regular intervals for life. The payments end at death.

Joint and survivor annuities – The first annuitant receives a definite amount at regular intervals for life. After he or she dies, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant may or may not differ from the amount paid to the first annuitant.

Variable annuities – You receive payments that may vary in amount for a specified length of time or for life. The amounts you receive may depend upon such variables as profits earned by the pension or annuity funds, cost-of-living indexes, or earnings from a mutual fund.

Disability pensions – You receive disability payments because you retired on disability and haven't reached minimum retirement age.

RECEIVING BENEFITS FROM MORE THAN ONE PROGRAM

You may receive employee plan benefits from more than one program under a single trust or plan of your employer. If you participate in more than one program, you may have to treat each as a separate pension or annuity contract, depending upon the facts in each case. Also, you may be considered to have received more than one

pension or annuity. Your former employer or the plan administrator should be able to tell you if you have more than one contract.

Example:

Your employer set up a noncontributory profit-sharing plan for its employees. The plan provides that the amount held in the account of each participant will be paid when that participant retires. Your employer also set up a contributory defined benefit pension plan for its employees providing for the payment of a lifetime pension to each participant after retirement.

The amount of any distribution from the profit-sharing plan depends on the contributions (including allocated forfeitures) made for the participant and the earnings from those contributions. Under the pension plan, however, a formula determines the amount of the pension benefits. The amount of contributions is the amount necessary to provide that pension.

Each plan is a separate program and a separate contract. If you get benefits from these plans, you must account for each separately, even though the benefits from both may be included in the same check.

(Distributions from a designated Roth account are treated separately from other distributions from the plan.)

IRS TAX PUBLICATION 575, PENSION AND ANNUITY INCOME

IRS Publication 575 is updated every tax year. It covers the tax treatment of distributions from pension and annuity plans and also shows how to report the income on the individual's tax return. How these distributions are taxed depends on whether they are periodic payments, or amounts that are paid at regular intervals over several years, or non-periodic payments, which are amounts not received as an annuity. It covers the following topics:

- How to figure the tax-free part of periodic payments under a pension or annuity plan, including using a worksheet for payments under a qualified plan;
- How to figure the tax-free part of non-periodic payments from qualified and nonqualified plans and how to use the optional methods to figure the tax on lump sum distributions from pension, stock bonus, and profit sharing plans;
- How to roll over certain distributions from a retirement plan into another retirement plan or IRA;

- How to report disability payments, and how beneficiaries and survivors of employees and retirees must report benefits paid to them;
- How to report railroad retirement benefits; and
- When additional taxes on certain distributions may apply including the tax on early distributions and the tax on excess accumulation.

Publication 575 does not cover the tax treatment of funds from nonqualified plans such as commercial annuities. Information on this treatment is available in IRS Publication 939, General Rule for Pensions and Annuities.

In addition, the publication does not cover benefits from retired government employees or their beneficiaries, which are covered in IRS Publication 721, Tax Guide to U.S. Civil Service Retirement Benefits.

Under the **Simplified Method**, you figure the tax-free part of each annuity payment by dividing your cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Under the Simplified Method, you figure the tax-free part of each annuity payment by dividing your cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you meet both of the following conditions.

1. You receive your pension or annuity payments from any of the following plans.
    a. A qualified employee plan.
    b. A qualified employee annuity.
    c. A tax-sheltered annuity plan (403(b) plan).
2. On your annuity starting date, at least one of the following conditions applies to you.
    a. You are under age 75.

b. You are entitled to less than 5 years of guaranteed payments.

If your annuity starting date is after July 1, 1986, and before November 19, 1996, and you chose to use the Simplified Method, you must continue to use it each year that you recover part of your cost. You could have chosen to use the Simplified Method if your annuity is payable for your life (or the lives of you and your survivor annuitant) and you met both the conditions listed earlier.

RECEIPT OF ANNUITY PAYMENTS

If you receive annuity payments under a variable annuity plan or contract, you recover your cost tax free under either the Simplified Method or the General Rule. For a variable annuity paid under a qualified plan, the Simplified Method is generally used. For a variable annuity paid under a nonqualified plan (including a contract bought directly from the issuer), a special computation under the General Rule, Publication 939 must be used.

IRS PUBLICATION 939, GENERAL RULE

This publication provides information needed to determine the tax treatment of pension and annuity income under the General Rule. Generally, each monthly annuity payment is made up of two parts—the tax-free part that is a return of net cost, and the taxable balance.

In tax years prior to 2018, user fees were allowed as miscellaneous itemized deductions subject to two percent (2%) of adjusted gross income (AGI) limit. However, under the Tax Cuts and Jobs Act (TCJA), miscellaneous itemized deductions are suspended for tax years 2018 through 2025, and therefore user fees aren't allowed for tax years beginning after 2017 and before 2026.

The General Rule is one of the two methods used to figure the tax-free part of each annuity payment based on the ratio of investment in the contract to the total expected return. The other method is the Simplified Method, which was discussed earlier in Publication 575, Pension and Annuity Income.

This publication (939) must be used if pension or annuity payments are received from:

- A nonqualified plan (i.e., private annuity, purchased commercial annuity, nonqualified employee plan); or
- A qualified plan **if**:

    - The annuity starting date is before November 19, 1996 (and after July 1, 1986), and you don't qualify to use, or didn't choose to use, the Simplified Method; or
    - The annuity starting date is after November 18, 1996, and as of that date you are age 75 or over and the annuity payments are guaranteed for at least 5 years.
- If the annuity starting date was between July 1, 1986, and November 19, 1996, either the Simplified Method or the General Rule can be used. This choice, however, is irrevocable and applied to all later annuity payments.

Such qualified plans refer to qualified employee plans, qualified employee annuities, and tax-sheltered annuity plans or contracts.

Beginning in 2013, distributions from an annuity under a nonqualified plan are considered net income investment income for the purposes of figuring the net investment income tax (NIIT).

Death benefit exclusion — If you are the beneficiary of a deceased employee (or former employee) who died before August 21, 1996, you may qualify for a death benefit exclusion of up to $5,000. The beneficiary of a deceased employee who died after August 20, 1996, won't qualify for the death benefit exclusion.

The General Rule cannot be used if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions are application.

ADDITIONAL IRS INFORMATION

Form 4972 – Tax on lump sum distributions. Use this form to figure the tax on a qualified lump sum distribution using the 20% capital gain election, the 10-year tax option, or both.

Form 5329 – Additional taxes on qualified plans (including IRAs) and other tax-favored accounts. Use this form to report additional taxes on IRAs, other qualified retirement plans, modified endowment contracts, Coverdell ESAs, QTPs, Archer MSAs, or HSAs.

Form 8915 – Qualified disaster retirement plan distributions and repayments. Use Form 8915-A if you were adversely affected by a 2016 disaster and you received a distribution that qualifies for favorable tax treatment. Use Form 8915-B if you were

adversely affected by a 2017 disaster and you received a distribution that qualifies for favorable tax treatment.

KEY POINTS TO PONDER

- The exclusion ratio only applies to nonqualified annuities, and is the percentage of an investor's return that is not subject to taxes.
- Failure to take the required minimum distributions when due will result in a penalty equal to 50% of the amount of the distribution. In addition, ordinary income taxes are due on the entire amount.
- A 10% penalty will be assessed for premature annuity withdrawals.
- All annuities are subject to the 10% penalty tax on premature distributions; exceptions include unreimbursed medical expenses, medical insurance payments, disability, death, and higher education expenses.
- Amounts withdrawn because of the death of an annuity owner or annuitant are taxed as a full withdrawal; the gain over the investment is taxed as ordinary income.
- For all annuities starting dates after December 31, 1986, payments become fully taxable after the contract owner recovers the total of all premiums paid into the contract.

CHAPTER 10 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. The _____ is the percentage of an investor's return that is not subject to taxes.

   a) exclusion ratio
   b) barring ratio
   c) segregation limit
   d) marginalization limit

2. The exclusion ratio applies only to _____ annuities.

   a) variable
   b) fixed
   c) nonqualified
   d) qualified

3. After the annuity contract owner has lived beyond his life expectancy as calculated, how are the income payments taxed?

   a) Taxation is cut in half.
   b) They become fully taxable.
   c) They do not change.
   d) They become totally tax-exempt.

CHAPTER 11

ANNUITY SUITABILITY REGULATION

Suitability is always a matter for individual determination. Only a well-informed consumer can make an appropriate decision; therefore, it is important that all the features and benefits of the annuity be fairly and accurately communicated to a prospective buyer.

Annuities are complex financial instruments. As annuity producers, we sell an intangible product that cannot be evaluated like a tangible product. The value of what we sell is often not easy for the consumer to grasp, and the contracts by necessity are full of legal terms, exceptions, and contingencies. The average consumer will not fully understand an annuity contract, so they must trust the person selling them the product. Most often this trust is well deserved, but this does create an environment where the consumer can be misled and enter into a transaction that is not in their best interest.

Over the past years, insurance commissioners have been closely monitoring complaints from consumers regarding annuity sales. While the total number of complaints remains low relative to other lines of insurance, the statistics can indicate a troubling trend over time. Each and every complaint is reviewed and investigated by the respective state Department of Insurance. Since 2004, more than 75% of the annuity complaints reported by state regulators to the NAIC have been resolved in favor of the consumer.

IMPORTANCE OF SUITABILITY CONDUCT

What meaning then does suitability conduct hold for an insurance agent? It calls for all agents to go beyond matter-of-fact transactions in which the customer is a mere number.

Being an effective insurance agent requires that you make it your business to match your clients to the policy most appropriate for their needs. This requires you to go beyond the call of duty and really know your clients. When a person consults you for advice on the best policy, you will be required to give them the policy that is best suited for them.

ANTICIPATING NEEDS

Change they say is the only constant. Life is always changing, as are insurance needs. No matter how responsible an agent you are, you cannot really predict life for your clients and give total coverage for each need—you will definitely need to have a road map for your client of things to come. An agent, despite the confusion in life, is expected to anticipate the needs of the client, and provide coverage for it. An agent needs to be trained to anticipate client needs in this ever-changing world. The task on hand is to acquire skills and be wary of threats as well as opportunities. The career growth of an agent depends on the aptitude to anticipate future problems and events. This is to say that the future and the capability to know customer needs are linked. The future brings in change that changes client needs. It only follows that a smart agent would need to adapt through the interpretation of future changes.

Future changes impact the insurance world and an agent's business. Though an agent cannot predict or see into future changes, he/she can make an educated guess based on the current state of affairs. As an example, by analyzing the growing gap between the rich and the poor, one can deduce that soon there will be people who do not have as much buying capacity as they used to. An agent can then plan to review some of the products to match their lack of buying strength but still cover their needs. Income losses, market fluctuations, inflation, unemployment are all issues that the smart agent needs to understand and accordingly anticipate the changing needs and then tailor the product to cover those needs.

The smart agent of today would keep an eye on these, to gauge and anticipate changing insurance needs of the future.

CAPITAL NEEDS ANALYSIS

The capital needs analysis method helps an agent to maintain **suitable sales conduct**—assessing a client not only according to age, occupation and income earned, but also their capital needs. Through the use of a capital needs worksheet, an agent can analyze the following aspects.

- **Family Income** — The most common aim of life insurance is to provide for the family in case of the breadwinner's demise. By examining the family's capital needs, an agent can ascertain the correct life insurance plan that can create the capital necessary to address the family's income gap.
- **Debt and Repayment** — Analyzing debts that a client has helps an agent gauge the lump sum capital needs to make repayments. Be it home

mortgages, or business debts, decisions can be contemplated to pay off debt within a period of time with a fund created from life insurance proceeds.

- **Miscellaneous Capital Requirements** — A client might have capital needs to cover children's college expenses or a reserve fund for emergencies.
- **Estate Settlements** — Capital needs to cover burial and funeral taxes, estate taxes, and uninsured medical expenses must be accounted for to decide the life insurance coverage. Where the client stays would be a factor as each state has varying death taxes as well as any tax liabilities a surviving spouse might have to bear.
- **Available Assets** — This analysis also takes into account the assets currently at the client's disposal in terms of savings accounts, real estate property, other investments, etc. This helps the agent decide the amount of insurance a client can buy or if the client would have the need to raise capital; for example, to create pension funds.

The analysis of all the discussed factors enables the agent to arrive at the client's net capital requirement that can be addressed by life insurance. The agent examines the capital needs and the income currently available to decide on the life insurance amount needed at the present time. Assuming that the client is the breadwinner, should there be a gap of $800,000 at his or her demise, due care demands that the agent suggest life insurance coverage for $800,000.

Care needs to be taken to **avoid underinsuring** as well as **over insuring** the client. Should the client be incapable of sustaining high premiums or simply doesn't want to, the agent needs to suggest lower amounts of coverage. An agent should take due care to explain how best a client can remove life insurance proceeds from his/her taxable estate—an insurance trust or transfer of ownership. The agent should explain that while the client can avoid federal taxation by transferring ownership of a policy to another person, ownership transfer is irrevocable. Hence, the client should be alerted to such issues as divorce and competency when planning to name the new owner. Due care would also require that the agent refer the client to an experienced estate planning attorney in case of estate tax concerns.

SUGGESTED DUE CARE QUERIES

Overall, agents should take care to pay attention to the details and get answers to a list of due care queries regarding life insurance, such as the following.

- *Does the client already have death benefit plans; for example, survivor's income or association group life plans?*

- *Who other than the client is being insured?*
- *Is there life insurance available that covers a married couple together for common or shared misfortunes?*
- *Are the death benefits matching the client needs?*
- *Does the client need coverage for business or personal debts or dependents requiring special care?*
- *Will it benefit the client to have a waiver of premium?*
- *Will accidental death benefits help the client to have or should he/she opt for a lower premium?*
- *To what age is the coverage guaranteed renewable?*
- *Is it possible for customers to change existing policies and is he/she healthy enough to justify this change?*
- *Is the life insurance coverage level term or decreasing term?*
- *What are the policy dividends and how is the client making use of them?*
- *What kinds of settlement options does the policy provide for in case of death? Is it a lump sum amount?*

SUITABILITY – A BRIEF SUMMATION

The crux of the matter involved is knowing the client's needs and matching those needs to the right (suitable) product. However, it is also important to ensure that to cover certain needs, an agent might have to look beyond insurance solutions. An agent cannot just cater to a single need or aim for only a sale. It goes beyond notching the sales numbers. It is taking suitability wherein an agent uncovers multiple requirements of a client and seeks to find suitable coverage and protection for the client with the help of multiple solutions.

It is important to anticipate client needs and find a solution that covers for the likely eventualities that might emerge from various issues ranging from the change in a child's decision to study medicine or the inflated living costs of the future. Additionally, suitability would require seeking solutions outside of insurance to make certain that the client is really truly protected.

Suitability is multi-tiered — it is dynamic. While some clients simply want discounts, others want quality service and see the agent as a manager of their risks. People seeking insurance want products that are secure, trustworthy, provide value, and

safeguard assets. No longer, however, are agents going to serve a one-solution-for-all needs population. The world is changing all the time and suitability skills have to be honed to cater to these new customers.

Suitability requirements are constantly changing and an agent needs to keep up. The traditional suitability methods can still serve as the groundwork but, as an agent, to address the client's risk, anticipate needs, find the appropriate solution and earn the client's respect, you must take insurance suitability beyond—to the next level.

Most states have or are currently passing legislation that not only requires adherence to current suitability regulations, including having a "reasonable basis" and exhibiting "enhanced due diligence," but also elaborates conditions to include the fact that any recommendation must be "**in the consumer's best interest**" as you will see.

THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

In 2019, the NAIC focused on eight issues central to their mission of protecting policyholders and advancing the state-based policy agenda.

- Annuity Suitability and Best Interest Standard
- Climate/Natural Catastrophe Risks & Resiliency
- Data, Innovation and Cyber
- Group Capital Calculation (GCC)
- Health Insurance
- Long-Term Care Insurance
- Macroprudential Initiative (MPI)
- International

NAIC members are the elected or appointed state government officials who, along with their departments and staff, regulate the conduct of insurance companies and agents in their respective state or territory.

In the studies provided in this course, however, we will focus on the first item listed—Annuity Suitability and Best Interest Standard.

NAIC SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION

This section covers the current status of the NAIC Suitability in Annuity Transactions Model Regulation (#275). This Model Regulation can be viewed as a template to be used in drafting the law to be passed at the state level. In several sections there are blanks where reference to state laws will be inserted and/or choice will be made by state legislators.

While all sections of this Model Regulation are important, Section 6 contains the duties of the insurer and producer under this regulation and should be reviewed carefully.

ANNUITY SUITABILITY AND BEST INTEREST STANDARD

In 2019, the NAIC Annuity Suitability (A) Working Group completed updates to Model #275, Suitability in Annuity Transactions Model Regulation, which began in November 2017. The goal of the Working Group was to seek clear, enhanced standards for annuity sales so consumers understand the products they purchase, are made aware of any material conflicts of interest, and are assured those selling the products do not place their financial interests above consumers' interests.

The revisions to Model #275 clarify that all recommendations by agents and insurers must be in the **best interest of the consumer** and that agents and carriers may not place their financial interest ahead of the consumers' interest in making a recommendation. The model now requires agents and carriers to act with "**reasonable diligence, care and skill**" in making recommendations. The revisions also include enhancements to the current model's supervision system to assist in compliance.

Several sections, and Appendices A, B, and C have been revised.

- Appendix A. Insurance Agent (Producer) Disclosure For Annuities
- Appendix B. Consumer Refusal to Provide Information
- Appendix C. Consumer Decision to Purchase an Annuity Not Based on a Recommendation

The final rule takes effect on June 30, 2020. Following is the revised version, which was adopted on December 30, 2019, showing all revisions in the normal underline and strikethrough method.

PURPOSE OF THE SUITABILITY MODEL ACT

Section 1. Purpose. A. The purpose of this regulation is to require producers, as defined in this regulation, to act in the best interest of the consumer when making a recommendation of an annuity and to require insurers to establish and maintain a system to supervise recommendations ~~and to set forth standards and procedures for recommendations to consumers that result in a transaction involving annuity products~~ so that the insurance needs and financial objectives of consumers at the time of the transaction are ~~appropriately~~ effectively addressed.

B. Nothing herein shall be construed to create or imply a private cause of action for a violation of this regulation or to subject a producer to civil liability under the best interest standard of care outlined in Section 6 of this regulation or under standards governing the conduct of a fiduciary or a fiduciary relationship.

Drafting Note: The language of subsection B comes from the NAIC Unfair Trade Practices Act. If a State has adopted different language, it should be substituted for subsection B.

Drafting Note: Section 989J of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") specifically refers to this model regulation as the "Suitability in Annuity Transactions Model Regulation." Section 989J of the Dodd-Frank Act confirmed this exemption of certain annuities from the Securities Act of 1933 and confirmed state regulatory authority. This regulation is a successor regulation that exceeds the requirements of the 2010 model regulation.

SCOPE OF THE SUITABILITY MODEL ACT

Section 2. Scope. This regulation shall apply to any sale or recommendation ~~to purchase, exchange or replace~~ of an annuity ~~made to a consumer by an insurance producer, or an insurer where no producer is involved, that results in the purchase, exchange or replacement recommended~~.

CONFERRED AUTHORITY

Section 3. Authority. This regulation is issued under the authority of [insert reference to state enabling legislation].

EXEMPTIONS TO THE SUITABILITY MODEL ACT

Section 4. Exemptions. Unless otherwise specifically included, this regulation shall not apply to recommendations involving:

A. Direct response solicitations by insurers where there is no recommendation based on information collected from the consumer pursuant to this regulation;

B. Contracts used to fund:

(1) An employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA);

(2) A plan described by sections 401(a), 401(k), 403(b), 408(k) or 408(p) of the Internal Revenue Code (IRC), as amended, if established or maintained by an employer;

(3) A government or church plan defined in section 414 of the IRC, a government or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under section 457 of the IRC;

(4) A nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor;

C.~~(5)~~ Settlements of or assumptions of liabilities associated with personal injury litigation or any dispute or claim resolution process; or

D.~~(6)~~ Formal prepaid funeral contracts.

DEFINITIONS USED IN THE CONTEXT OF THE SUITABILITY MODEL ACT

Section 5. Definitions. A. "**Annuity**" means an annuity that is an insurance product under State law that is individually solicited, whether the product is classified as an individual or group annuity.

B. "**Cash compensation**" means any discount, concession, fee, service fee, commission, sales charge, loan, override, or cash benefit received by a producer in connection with the recommendation or sale of an annuity from an insurer, intermediary, or directly from the consumer.

C. "**Consumer profile information**" means information that is reasonably appropriate to determine whether a recommendation addresses the consumer's financial situation, insurance needs and financial objectives, including, at a minimum, the following:

(1) Age;

(2) Annual income;

(3) Financial situation and needs, including debts and other obligations;

(4) Financial experience;

(5) Insurance needs;

(6) Financial objectives;

(7) Intended use of the annuity;

(8) Financial time horizon;

(9) Existing assets or financial products, including investment, annuity and insurance holdings;

(1) Liquidity needs;

(11) Liquid net worth;

(12) risk tolerance, including but not limited to, willingness to accept nonguaranteed elements in the annuity;

(13) Financial resources used to fund the annuity; and

(14) Tax status.

~~B.~~D. "**Continuing education credit**" or "**CE credit**" means one continuing education credit as defined in [insert reference in State law or regulations governing producer continuing education course approval].

~~C.~~E. "**Continuing education provider**" or "**CE provider**" means an individual or entity that is approved to offer continuing education courses pursuant to [insert reference in State law or regulations governing producer continuing education course approval].

~~D.~~F. "**FINRA**" means the Financial Industry Regulatory Authority or a succeeding agency.

~~E.~~G. "**Insurer**" means a company required to be licensed under the laws of this state to provide insurance products, including annuities.

~~F. "Insurance producer" means a person required to be licensed under the laws of this state to sell, solicit or negotiate insurance, including annuities.~~

H. "**Intermediary**" means an entity contracted directly with an insurer or with another entity contracted with an insurer to facilitate the sale of the insurer's annuities by producers.

I. (1) "**Material conflict of interest**" means a financial interest of the producer in the sale of an annuity that a reasonable person would expect to influence the impartiality of a recommendation.

(2) "**Material conflict of interest**" does not include cash compensation or non-cash compensation.

J. "**Non-cash compensation**" means any form of compensation that is not cash compensation, including, but not limited to, health insurance, office rent, office support and retirement benefits.

K. "**Nonguaranteed elements**" means the premiums, credit interest rates (including any bonus), benefits, values, dividends, non-interest based credits, charges or elements of formulas used to determine any of these that are subject to company discretion and are not guaranteed at issue. An element is considered nonguaranteed if any of the underlying nonguaranteed elements are used in its calculation.

L. "**Producer**" means a person or entity required to be licensed under the laws of this state to sell, solicit or negotiate insurance, including annuities. For purposes of this regulation, "producer" includes an insurer where no producer is involved.

~~G~~M. (1) "**Recommendation**" means advice provided by ~~an insurance~~ a producer~~, or an insurer where no producer is involved,~~ to an individual consumer that was intended to result or does result ~~results~~ in a purchase, an exchange or a replacement of an annuity in accordance with that advice.

(2) Recommendation does not include general communication to the public, generalized customer services assistance or administrative support, general educational information and tools, prospectuses, or other product and sales material.

~~H~~N. "**Replacement**" means a transaction in which a new ~~policy or contract~~ annuity is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer ~~if there is no~~whether or not a producer is involved, that by reason of the transaction, an existing annuity or other insurance policy ~~or contract~~ has been or is to be any of the following:

(1) Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer or otherwise terminated;

(2) Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;

(3) Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;

(4) Reissued with any reduction in cash value; or

(5) Used in a financed purchase.

~~I. "Suitability information" means information that is reasonably appropriate to determine the suitability of a recommendation, including the following:~~

~~(1) Age;~~

~~(2) Annual income;~~

~~(3) Financial situation and needs, including the financial resources used for the funding of the annuity;~~

~~(4) Financial experience;~~

~~(5) Financial objectives;~~

~~(6) Intended use of the annuity;~~

~~(7) Financial time horizon;~~

~~(8) Existing assets, including investment and life insurance holdings;~~

~~(9) Liquidity needs;~~

~~(10) Liquid net worth;~~

~~(11) Risk tolerance; and~~

~~(12) Tax status.~~

O. "**SEC**" means the United States Securities and Exchange Commission.

Drafting Note: The definition of "replacement" above is derived from the NAIC Life Insurance and Annuities Replacement Model Regulation. If a State has a different definition for "replacement," the State should either insert the text of that definition in place of the definition above or modify the definition above to provide a cross-reference to the definition of "replacement" that is in State law or regulation.

DUTIES OF INSURERS AND PRODUCERS

Note: The revision of Section 6 strikes the word "insurance" so that the title of Section 6 is now "Duties of Insurers and Producers." [Section 6. Duties of Insurers and ~~Insurance~~ Producers]

Section 6. Duties of Insurers and Producers. A. Best Interest Obligations. A producer, when making a recommendation of an annuity, shall act in the best interest of the consumer under the circumstances known at the time the recommendation is made, without placing the producer's or the insurer's financial interest ahead of the consumer's interest. A producer has acted in the best interest of the consumer if they have satisfied the following obligations regarding care, disclosure, conflict of interest and documentation:

~~A. In recommending to a consumer the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance~~

~~transactions, the insurance producer, or the insurer where no producer is involved, shall have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer's suitability information, and that there is a reasonable basis to believe all of the following:~~

(1)(a) **Care Obligation**. The producer, in making a recommendation shall exercise reasonable diligence, care and skill to:

(i) Know the consumer's financial situation, insurance needs and financial objectives;

(ii) Understand the available recommendation options after making a reasonable inquiry into options available to the producer;

(iii) Have a reasonable basis to believe the recommended option effectively addresses the consumer's financial situation, insurance needs and financial objectives over the life of the product, as evaluated in light of the consumer profile information; and

(iv) Communicate the basis or bases of the recommendation.

(b) The requirements under subparagraph (a) of this paragraph include making reasonable efforts to obtain consumer profile information from the consumer prior to the recommendation of an annuity.

(c) The requirements under subparagraph (a) of this paragraph require a producer to consider the types of products the producer is authorized and licensed to recommend or sell that address the consumer's financial situation, insurance needs and financial objectives. This does not require analysis or consideration of any products outside the authority and license of the producer or other possible alternative products or strategies available in the market at the time of the recommendation. Producers shall be held to standards applicable to producers with similar authority and licensure.

(d) The requirements under this subsection do not create a fiduciary obligation or relationship and only create a regulatory obligation as established in this regulation.

(e) The consumer profile information, characteristics of the insurer, and product costs, rates, benefits and features are those factors generally relevant in making a determination whether an annuity effectively addresses the consumer's financial situation, insurance needs and financial objectives, but the level of importance of each factor under the care obligation of this

paragraph may vary depending on the facts and circumstances of a particular case. However, each factor may not be considered in isolation.

(f) The requirements under subparagraph (a) of this paragraph include having a reasonable basis to believe the consumer would benefit from certain features of the annuity, such as annuitization, death or living benefit or other insurance-related features.

(g) The requirements under subparagraph (a) of this paragraph apply to the particular annuity as a whole and the underlying subaccounts to which funds are allocated at the time of purchase or exchange of an annuity, and riders and similar producer enhancements, if any.

(h) The requirements under subparagraph (a) of this paragraph do not mean the annuity with the lowest one-time or multiple occurrence compensation structure shall necessarily be recommended.

(i) The requirements under subparagraph (a) of this paragraph do not mean the producer has ongoing monitoring obligations under the care obligation under this paragraph, although such an obligation may be separately owed under the terms of a fiduciary, consulting, investment advising or financial planning agreement between the consumer and the producer.

(j) In the case of an exchange or replacement of an annuity, the producer shall consider the whole transaction, which includes taking into consideration whether:

(i) The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits, such as death, living or other contractual benefits, or be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements;

(ii) The replacing product would substantially benefit the consumer in comparison to the replaced product over the life of the product; and

(iii) The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 60 months.

(k) Nothing in this regulation should be construed to require a producer to obtain any license other than a producer license with the appropriate line of authority to sell, solicit or negotiate insurance in this state, including but not limited to any securities license, in order to fulfill the duties and obligations contained in this regulation; provided the producer does not give advice or provide services that are otherwise subject to securities laws or engage in any other activity requiring other professional licenses.

(2) **Disclosure obligation**.

(a) Prior to the recommendation or sale of an annuity, the producer shall prominently disclose to the consumer on a form substantially similar to Appendix A:

(i) A description of the scope and terms of the relationship with the consumer and the role of the producer in the transaction;

(ii) An affirmative statement on whether the producer is licensed and authorized to sell the following products:

(I) Fixed annuities;

(II) Fixed indexed annuities;

(III) Variable annuities;

(IV) Life insurance;

(V) Mutual funds;

(VI) Stocks and bonds; and

(VII) Certificates of deposit;

(iii) An affirmative statement describing the insurers the producer is authorized, contracted (or appointed), or otherwise able to sell insurance products for, using the following descriptions:

(I) One insurer;

(II) From two or more insurers; or

(III) From two or more insurers although primarily contracted with one insurer.

(iv) A description of the sources and types of cash compensation and non-cash compensation to be received by the producer, including whether the producer is to be compensated for the sale of a recommended annuity by commission as part of premium or other remuneration received from the insurer, intermediary or other producer or by fee as a result of a contract for advice or consulting services; and

(v) A notice of the consumer's right to request additional information regarding cash compensation described in subparagraph (b) of this paragraph;

Drafting Note: If a state approves forms, a state should add language to subparagraph (a) reflecting such approvals.

(b) Upon request of the consumer or the consumer's designated representative, the producer shall disclose:

(i) A reasonable estimate of the amount of cash compensation to be received by the producer, which may be stated as a range of amounts or percentages; and

(ii) Whether the cash compensation is a one-time or multiple occurrence amount, and if a multiple occurrence amount, the frequency and amount of the occurrence, which may be stated as a range of amounts or percentages; and

(c~~1~~) Prior to or at the time of the recommendation or sale of an annuity, the producer shall have a reasonable basis to believe ~~The~~the consumer has been ~~reasonably~~ informed of various features of the annuity, such as the potential surrender period and surrender charge, potential tax penalty if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, investment advisory fees, any annual fees, potential charges for and features of riders or other options of the annuity, limitations on interest returns, potential changes in nonguaranteed elements of the annuity, insurance and investment components and market risk.

Drafting Note: If a State has adopted the NAIC Annuity Disclosure Model Regulation, the State should insert an additional phrase in ~~paragraph (1)~~ subparagraph (c) above to explain that the requirements of this section are intended to supplement and not replace the disclosure requirements of the NAIC Annuity Disclosure Model Regulation.

~~(2) The consumer would benefit from certain features of the annuity, such as tax-deferred growth, annuitization or death or living benefit;~~

~~(3) The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information; and~~

~~(4) In the case of an exchange or replacement of an annuity, the exchange or replacement is suitable including taking into consideration whether:~~

~~(a) The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living or other contractual benefits), or be subject to increased fees, investment advisory fees or charges for riders and similar product enhancements;~~

~~(b) The consumer would benefit from product enhancements and improvements; and~~

~~(c) The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding 36 months.~~

(3) **Conflict of interest obligation**. A producer shall identify and avoid or reasonably manage and disclose material conflicts of interest, including material conflicts of interest related to an ownership interest.

(4) **Documentation obligation**. A producer shall at the time of recommendation or sale:

(a) Make a written record of any recommendation and the basis for the recommendation subject to this regulation;

(b) Obtain a consumer signed statement on a form substantially similar to Appendix B documenting:

(i) A customer's refusal to provide the consumer profile information, if any; and

(ii) A customer's understanding of the ramifications of not providing his or her consumer profile information or providing insufficient consumer profile information; and

(c) Obtain a consumer signed statement on a form substantially similar to Appendix C acknowledging the annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the producer's recommendation.

Drafting Note: If a state approves forms, a state should add language to subparagraphs (b) and (c) of this paragraph reflecting such approvals.

~~B. Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.~~

~~C. Except as permitted under subsection D, an insurer shall not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity is suitable based on the consumer's suitability information.~~

(5) Application of the best interest obligation. Any requirement applicable to a producer under this subsection shall apply to every producer who has exercised material control or influence in the making of a recommendation and has received direct compensation as a result of the recommendation or sale,

regardless of whether the producer has had any direct contact with the consumer. Activities such as providing or delivering marketing or educational materials, product wholesaling or other back office product support, and general supervision of a producer do not, in and of themselves, constitute material control or influence.

~~D.~~B. **Transactions not based on a recommendation**.

(1) Except as provided under paragraph (2) ~~of this subsection, neither an insurance~~ a producer, ~~nor an insurer,~~ shall have ~~any~~ no obligation to a consumer under Subsection A(1) ~~or C~~ related to any annuity transaction if

(a) No recommendation is made;

(b) A recommendation was made and was later found to have been prepared based on materially inaccurate information provided by the consumer;

(c) A consumer refuses to provide relevant ~~suitability~~ consumer profile information and the annuity transaction is not recommended; or

(d) A consumer decides to enter into an annuity transaction that is not based on a recommendation of ~~the insurer or~~ the ~~insurance~~ producer.

(2) An insurer's issuance of an annuity subject to paragraph (1) shall be reasonable under all the circumstances actually known to the insurer at the time the annuity is issued.

C. **Supervision system**.

(1) Except as permitted under subsection B, an insurer may not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives based on the consumer's consumer profile information.

~~(E) An insurance producer or, where no insurance producer is involved, the responsible insurer representative, shall at the time of sale:~~

~~(1) Make a record of any recommendation subject to section 6A of this regulation;~~

~~(2) Obtain a customer signed statement documenting a customer's refusal to provide suitability information, if any; and~~

~~(3) Obtain a customer signed statement acknowledging that an annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.~~

~~F. (1)~~(2) An insurer shall establish and maintain a supervision system that is reasonably designed to achieve the insurer's and its ~~insurance~~ producers' compliance with this regulation, including, but not limited to, the following:

(a) The insurer shall establish and maintain reasonable procedures to inform its ~~insurance~~ producers of the requirements of this regulation and shall incorporate the requirements of this regulation into relevant ~~insurance~~ producer training manuals;

(b) The insurer shall establish and maintain standards for ~~insurance~~ producer product training and shall establish and maintain reasonable procedures to require its ~~insurance~~ producers to comply with the requirements of section 7 of this regulation;

(c) The insurer shall provide product-specific training and training materials which explain all material features of its annuity products to its ~~insurance~~ producers;

(d) The insurer shall establish and maintain procedures for the review of each recommendation prior to issuance of an annuity that are designed to ensure ~~that~~ there is a reasonable basis to determine that ~~a recommendation is suitable.~~ the recommended annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives. Such review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;

(e) The insurer shall establish and maintain reasonable procedures to detect recommendations that are not ~~suitable~~in compliance with subsections A, B, D and E. This may include, but is not limited to, confirmation of the consumer's ~~suitability~~ consumer profile information, systematic customer surveys, producer and consumer interviews, confirmation letters, producer statements or attestations and programs of internal monitoring. Nothing in this subparagraph prevents an insurer from complying with this subparagraph by applying sampling procedures, or by confirming the ~~suitability~~ consumer profile information or other required information under this section after issuance or delivery of the annuity; ~~and~~

(f) The insurer shall establish and maintain reasonable procedures to assess, prior to or upon issuance or delivery of an annuity, whether a producer has

provided to the consumer the information required to be provided under this section;

(g) The insurer shall establish and maintain reasonable procedures to identify and address suspicious consumer refusals to provide consumer profile information;

(h) The insurer shall establish and maintain reasonable procedures to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific annuities within a limited period of time. The requirements of this subparagraph are not intended to prohibit the receipt of health insurance, office rent, office support, retirement benefits or other employee benefits by employees as long as those benefits are not based upon the volume of sales of a specific annuity within a limited period of time; and

Drafting Note: The intent of this subparagraph (h) is to prohibit sales contests, sales quotas, bonuses and non-cash compensation based on the sale of a particular product within a limited period of time, but not to prohibit general incentives regarding the sales of a company's products with no emphasis on any particular product.

~~(f)~~(i) The insurer shall annually provide a written report to senior management, including to the senior manager responsible for audit functions, which details a review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.

~~(2)~~(3)(a) Nothing in this subsection restricts an insurer from contracting for performance of a function (including maintenance of procedures) required under ~~paragraph (1)~~ this subsection. An insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties pursuant to section 8 of this regulation regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with subparagraph (b) of this paragraph.

(b) An insurer's supervision system under ~~paragraph (1)~~ this subsection shall include supervision of contractual performance under this subsection. This includes, but is not limited to, the following:

(i) Monitoring and, as appropriate, conducting audits to assure that the contracted function is properly performed; and

(ii) Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a

reasonable basis to represent, and does represent, that the function is properly performed.

~~(3)~~(4) An insurer is not required to include in its system of supervision ~~an insurance~~

(a) A producer's recommendations to consumers of products other than the annuities offered by the insurer; or

(b) Include consideration of or comparison to options available to the producer or compensation relating to those options other than annuities or other products offered by the insurer.

~~G~~D. **Prohibited Practices**. Neither a producer nor an insurer shall ~~An insurance producer shall not~~ dissuade, or attempt to dissuade, a consumer from:

(1) Truthfully responding to an insurer's request for confirmation of the ~~suitability~~consumer profile information;

(2) Filing a complaint; or

(3) Cooperating with the investigation of a complaint.

~~H~~E. **Safe harbor**.

(1) Recommendations and sales of annuities ~~Sales~~ made in compliance with comparable standards ~~FINRA requirements pertaining to suitability and supervision of annuity transactions~~ shall satisfy the requirements under this regulation. This subsection applies to ~~FINRA broker-dealer~~ all recommendations and sales of annuities made by financial professionals in compliance with business rules, controls and procedures that satisfy a comparable standard even if such standard would not otherwise apply to the product or recommendation at issue ~~if the suitability and supervision is similar to those applied to variable annuity sales~~. However, nothing in this subsection shall limit the insurance commissioner's ability to investigate and enforce ~~(including investigate)~~ the provisions of this regulation.

Drafting Note: Non-compliance with comparable standards ~~FINRA requirements~~ means that the ~~broker-dealer transaction~~ recommendation or sale is subject to compliance with the ~~suitability~~ requirements of this regulation.

(2) Nothing in paragraph (1) shall limit the insurer's obligation to comply with Section 6C(1) of this regulation, although the insurer may base its analysis on information received from either the financial professional or the entity supervising the financial professional.

~~(2)~~(3) For paragraph (1) to apply, an insurer shall:

(a) Monitor the ~~FINRA member broker-dealer~~ relevant conduct of the financial professional seeking to rely on paragraph (1) or the entity responsible for supervising the financial professional, such as the financial professional's broker-dealer or an investment adviser registered under federal [or state] securities laws using information collected in the normal course of an insurer's business; and

(b) Provide to the ~~FINRA member broker-dealer~~ entity responsible for supervising the financial professional seeking to rely on paragraph (1), such as the financial professional's broker-dealer or investment adviser registered under federal [or state] securities laws, information and reports that are reasonably appropriate to assist ~~the FINRA member broker-dealer such entity~~ to maintain its supervision system.

(4) For purposes of this subsection, "financial professional" means a producer that is regulated and acting as:

(a) A broker-dealer registered under federal [or state] securities laws or a registered representative of a broker-dealer;

(b) An investment adviser registered under federal [or state] securities laws or an investment adviser representative associated with the federal [or state] registered investment adviser; or

(c) A plan fiduciary under Section 3(21) of the Employee Retirement Income Security Act of 1974 (ERISA) or fiduciary under Section 4975(e)(3) of the Internal Revenue Code (IRC) or any amendments or successor statutes thereto.

Drafting Note: The requirement that a producer be "regulated and acting" as a broker-dealer, a registered representative of a broker-dealer, an investment adviser, an investment adviser representative or a plan fiduciary means that a producer who is not explicitly acting in compliance with the relevant comparable standards, as specified in paragraph (4) below, is not eligible for this safe harbor and is subject to compliance with the requirements of this regulation.

(5) For purposes of this subsection, "**comparable standards**" means:

(a) With respect to broker-dealers and registered representatives of broker-dealers, applicable SEC and FINRA rules pertaining to best interest obligations and supervision of annuity recommendations and sales, including, but not limited to, Regulation Best Interest and any amendments or successor regulations thereto;

(b) With respect to investment advisers registered under federal [or state] securities laws or investment adviser representatives, the fiduciary duties and all other requirements imposed on such investment advisers or investment adviser representatives by contract or under the Investment Advisers Act of 1940 [or applicable state securities law], including but not limited to, the Form ADV and interpretations; and

Drafting Note: State-registered investment advisers in this safe harbor are included in brackets so that each individual state that implements this model regulation may determine whether to include the state-regulated investment advisers. Given the varying treatment of annuities, particularly variable annuities, under state law, the varying structures of state securities and insurance departments, and the varying levels of cooperation between the two agencies, this is a decision best made in each individual state.

(c) With respect to plan fiduciaries or fiduciaries, means the duties, obligations, prohibitions and all other requirements attendant to such status under ERISA or the IRC and any amendments or successor statutes thereto.

PRODUCER TRAINING REQUIREMENTS

Note: The revision of Section 7 strikes the word "insurance" so that the title of Section 7 is now "Producer Training." [Section 7. ~~Insurance~~ Producer Training]

Section 7. Producer Training. A. ~~An insurance~~ A 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. ~~An insurance~~ A producer may rely on insurer-provided product-specific training standards and materials to comply with this subsection.

B. (1) (a) ~~An insurance~~ A producer who engages in the sale of annuity products shall complete a one-time four (4) credit training course approved by the department of insurance and provided by the department of insurance-approved education provider.

(b) ~~Insurance p~~Producers who hold a life insurance line of authority on the effective date of this regulation and who desire to sell annuities shall complete the requirements of this subsection within six (6) months after the effective date of this regulation. Individuals who obtain a life insurance line of authority on or after the effective date of this regulation may not engage in the sale of annuities until the annuity training course required under this subsection has been completed.

(2) The minimum length of the training required under this subsection shall be sufficient to qualify for at least four (4) CE credits, but may be longer.

(3) The training required under this subsection shall include information on the following topics:

(a) The types of annuities and various classifications of annuities;

(b) Identification of the parties to an annuity;

(c) How fixed, variable and indexed annuity contract provisions affect consumers;

(d) The application of income taxation of qualified and nonqualified annuities;

(e) The primary uses of annuities; and

(f) Appropriate standard of conduct, sales practices, replacement and disclosure requirements.

(4) Providers of courses intended to comply with this subsection shall cover all topics listed in the prescribed outline and shall not present any marketing information or provide training on sales techniques or provide specific information about a particular insurer's products. Additional topics may be offered in conjunction with and in addition to the required outline.

(5) A provider of an annuity training course intended to comply with this subsection shall register as a CE provider in this State and comply with the rules and guidelines applicable to ~~insurance~~ producer continuing education courses as set forth in [insert reference to State law or regulations governing producer continuing education course approval].

(6) A producer who has completed an annuity training course approved by the department of insurance prior to [insert effective date of amended regulation] shall, within six (6) months after [insert effective date of amended regulation], complete either:

(a) A new four (4) credit training course approved by the department of insurance after [insert effective date of amended regulation]; or

(b) An additional one-time one (1) credit training course approved by the department of insurance and provided by the department of insurance-approved education provider on appropriate sales practices, replacement and disclosure requirements under this amended regulation.

~~(6)~~(7) Annuity training courses may be conducted and completed by classroom or self-study methods in accordance with [insert reference to State law or regulations governing producer continuing education course approval].

~~(7)~~(8) Providers of annuity training shall comply with the reporting requirements and shall issue certificates of completion in accordance with [insert reference to State law or regulations governing to producer continuing education course approval].

~~(8)~~(9) The satisfaction of the training requirements of another State that are substantially similar to the provisions of this subsection shall be deemed to satisfy the training requirements of this subsection in this State.

(10) The satisfaction of the components of the training requirements of any course or courses with components substantially similar to the provisions of this subsection shall be deemed to satisfy the training requirements of this subsection in this state.

~~(9)~~(11) An insurer shall verify that ~~an insurance~~ a producer has completed the annuity training course required under this subsection before allowing the producer to sell an annuity product for that insurer. An insurer may satisfy its responsibility under this subsection by obtaining certificates of completion of the training course or obtaining reports provided by commissioner-sponsored database systems or vendors or from a reasonably reliable commercial database vendor that has a reporting arrangement with approved insurance education providers.

COMPLIANCE MITIGATION, PENALTIES, AND ENFORCEMENT

Note: The revision of Section 8 adds the word "Enforcement" so that the title of Section 8 is now "Compliance Mitigation; Penalties; Enforcement." [Section 8. Compliance Mitigation; Penalties; Enforcement]

Section 8. Compliance Mitigation; Penalties; Enforcement. A. An insurer is responsible for compliance with this regulation. If a violation occurs, either because of the action or inaction of the insurer or its ~~insurance~~ producer, the commissioner may order:

(1) An insurer to take reasonably appropriate corrective action for any consumer harmed by a failure to comply with this regulation by the ~~insurer's,~~ insurer, an entity contracted to perform the insurer's supervisory duties or by ~~its insurance producer's, violation of this regulation~~ the producer;

(2) A general agency, independent agency or the ~~insurance~~ producer to take reasonably appropriate corrective action for any consumer harmed by the ~~insurance~~ producer's violation of this regulation; and

(3) Appropriate penalties and sanctions.

B. Any applicable penalty under [insert statutory citation] for a violation of this regulation may be reduced or eliminated [, according to a schedule adopted by the commissioner,] if corrective action for the consumer was taken promptly after a violation was not part of a pattern or practice.

Drafting Note: Subsection B above is intended to be consistent with the commissioner's discretionary authority to determine the appropriate penalty for a violation of this regulation. The language of subsection B is not intended to require that a commissioner impose a penalty on an insurer for a single violation of this regulation if the commissioner has determined that such a penalty is not appropriate.

Drafting Note: A State that has authority to adopt a schedule of penalties may wish to include the words in brackets. In that case, "shall" should be substituted for "may" in the same sentence. States should consider inserting a reference to the NAIC Unfair Trade Practices Act or the State's statute that authorizes the commissioner to impose penalties and fines.

C. The authority to enforce compliance with this regulation is vested exclusively with the commissioner.

RECORDKEEPING REQUIREMENTS

Note: The revision of Section 9 strikes the word "Optional" so that the title of Section 9 is now "Recordkeeping." [Section 9. ~~Optional~~ Recordkeeping]

Section 9. Recordkeeping. A. Insurers, general agents, independent agencies and ~~insurance~~ producers shall maintain or be able to make available to the commissioner records of the information collected from the consumer, disclosures made to the consumer, including summaries of oral disclosures, and other information used in making the recommendations that were the basis for insurance transactions for [insert number] years after the insurance transaction is completed by the insurer. An insurer is permitted, but shall not be required, to maintain documentation on behalf of ~~an insurance~~ a producer.

B. Records required to be maintained by this regulation may be maintained in paper, photographic, micro-process, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

EFFECTIVE DATE OF THE MODEL ACT

Section 10. Effective Date. The amendments to this regulation shall take effect [~~six (6)~~X] months after the date the regulation is adopted or on [insert date], whichever is later.[41]

APPENDIX A – INSURANCE AGENT DISCLOSURE FOR ANNUITIES

Note: For ease of reading, the document has foregone the underlining required for new text, as this is all new.

APPENDIX A

INSURANCE AGENT (PRODUCER) DISCLOSURE FOR ANNUITIES
Do Not Sign Unless You Have Read and Understand the Information in this Form

Date: _____

INSURANCE AGENT (PRODUCER) INFORMATION ("Me," "I," "My")

First Name: _____ Last Name: _____

Business/Agency Name: _____ Website: _____

Business Mailing Address: _____

Business Telephone Number: _____

Email Address: _____

National Producer Number in [state]: _____

CUSTOMER INFORMATION ("You," "Your")

First Name: _____ Last Name: _____

What Types of Products Can I Sell You?

I am licensed to sell annuities to you in accordance with state law. If I recommend that You buy an annuity, it means I believe that it effectively meets Your financial situation,

[41] NAIC, *Suitability in Annuity Transactions Model Regulation,* Dec. 30, 2019, https://content.naic.org/sites/default/files/inline-files/Model%20%23275-8%20Draft.pdf

insurance needs, and financial objectives. Other financial products, such as life insurance or stocks, bonds and mutual funds, also may meet Your needs.

I offer the following products:

☐ Fixed or Fixed Indexed Annuities

☐ Variable Annuities

☐ Life Insurance

I need a separate license to provide advice about or to sell non-insurance financial products. I have checked below any non-insurance financial products that I am licensed and authorized to provide advice about or to sell.

☐ Mutual Funds

☐ Stocks/Bonds

☐ Certificates of Deposits

Whose Annuities Can I Sell to You?

I am authorized to sell:

☐ Annuities from Only One (1) Insurer

☐ Annuities from Two or More Insurers although I primarily sell annuities from: _____

☐ Annuities from Two or More Insurers

How I'm Paid for My Work:

It's important for You to understand how I'm paid for my work. Depending on the particular annuity You purchase, I may be paid a commission or a fee. Commissions are generally paid to Me by the insurance company while fees are generally paid to Me by the consumer. If You have questions about how I'm paid, please ask Me.

Depending on the particular annuity You buy, I will or may be paid cash compensation as follows:

☐ Commission, which is usually paid by the insurance company or other sources. If other sources, describe: _____.

☐ Fees (such as a fixed amount, an hourly rate, or a percentage of your payment), which are usually paid directly by the customer.

☐ Other (Describe): _____

If you have questions about the above compensation I will be paid for this transaction, please ask me.

I may also receive other indirect compensation resulting from this transaction (sometimes called “non-cash” compensation), such as health or retirement benefits, office rent and support, or other incentives from the insurance company or other sources.

By signing below, you acknowledge that you have read and understand the information provided to you in this document.

_____
Customer Signature

_____
Date

_____
Agent (Producer) Signature

_____
Date

Table 11.1 – Appendix A, Insurance Agent (Producer) Disclosure for Annuities

Drafting Note: This disclosure may be adapted to fit the particular business model of the producer. As an example, if the producer only receives commission or only receives a fee from the consumer, the disclosure may be refined to fit that particular situation. This form is intended to provide an example of how to communicate producer compensation, but compliance with the regulation may also be achieved with more precise disclosure, including a written consulting, advising or financial planning agreement.

APPENDIX B – CUSTOMER REFUSAL TO PROVIDE INFORMATION

APPENDIX B

CONSUMER REFUSAL TO PROVIDE INFORMATION
Do Not Sign Unless You Have Read and Understand the Information in this Form

Why are you being given this form?

You’re buying a financial product – an annuity.

To recommend a product that effectively meets your needs, objectives and situation, the agent, broker, or company needs information about you, your financial situation, insurance needs and financial objectives.

If you sign this form, it means you have not given the agent, broker, or company some or all the information needed to decide if the annuity effectively meets your needs, objectives

and situation. You may lose protections and under the Insurance Code of [this state] if you sign this form or provide inaccurate information.

Statement of Purchase:

☐ I REFUSE to provide this information at this time.

☐ I have chosen to provide LIMITED information at this time.

_____

Customer Signature

_____

Date

Table 11.2 – Appendix B, Consumer Refusal to Provide Information

APPENDIX C – CONSUMER DECISION TO PURCHASE AN ANNUITY NOT BASED ON A RECOMMENDATION

APPENDIX C

Consumer Decision to Purchase an Annuity NOT Based on a Recommendation
Do Not Sign Unless You Have Read and Understand It.

Why are you being given this form? You are buying a financial product – an annuity.

To recommend a product that effectively meets your needs, objectives and situation, the agent, broker, or company has the responsibility to learn about you, your financial situation, insurance needs and financial objectives.

If you sign this form, it means you know that you're buying an annuity that was not recommended.

Statement of Purchaser:

I understand that I am buying an annuity, but the agent, broker or company did not recommend that I buy it. If I buy it **without a recommendation**, I understand I may lose protections under the Insurance Code of [this state].

_____

Customer Signature

_____

Date

_____

Agent (Producer) Signature

_____

Date

Table 11.3 – Appendix C, Consumer Decision to Purchase an Annuity NOT Based on a Recommendation[42]

NAIC RECOMMENDATION STANDARDS

(1) Prior to recommending a transaction involving an annuity to a consumer, an insurer and an insurance producer shall make every effort to obtain relevant information from the senior consumer.

(2) An insurer and an insurance producer shall make recommendations only of transactions that are appropriate to assist the senior consumer to meet the particular senior consumer's insurance needs and financial objectives.

(3) An insurer and an insurance producer shall not make a recommendation unless the insurer and the insurance producer comply with the standards, guidelines, procedures and data collection processes established by the insurer under Subsection B(2)(a) to (c) of this section.

IMPORTANT INFORMATION

(1) Occupation and occupational status;
(2) Marital status;
(3) Age;
(4) Number and type of dependents;
(5) Sources of income;
(6) Yearly income;
(7) The consumer's existing insurance;
(8) The consumer's insurance needs and objectives;
(9) The cost to the consumer and the consumer's ability to pay for the proposed transaction or transactions;
(10) Source of funds to pay premiums;
(11) Investment savings;
(12) Liquid net worth;
(13) Tax status;

Additional information and discussion:

- Risk tolerance
- Use of benefit – income or wealth transfer

[42] G:\GOVTREL\DATA\Health and Life\Life\Annuity Suitability WG 2017\Drafts\Model #275-8 Draft.docx

- Time horizon for the benefit need to help you determine the surrender period appropriate
- Other benefit sources – Social Security, retirement plans, other assets
- Health
- Liquidity of product solution
- Required minimum distributions
- Free withdrawals
- Withdrawal in excess of free amount
- Full surrender – penalties and impact on premiums
- Review tax ramifications of liquidity decisions

NAIC Life Insurance and Annuities Replacement Model Regulation

Mot states have adopted the most recent version of the NAIC model in a **substantially similar manner**. This requires states to adopt the model in its entirety but does allow for variations in style and format.

The purpose of this NAIC regulation is to regulate the activities of insurers and producers with respect to the replacement of existing life insurance and annuities; and to protect the interest of life insurance and annuity purchasers by establishing minimum standards of conduct to be observed in replacement or financed purchase transactions. The regulation is set forth to assure that purchasers receive information with which a decision can be made in his/her own best interest; reduce the opportunity for misrepresentation and incomplete disclosure; and establish penalties for failure to comply with the requirements of the regulation.

Table of Contents	
Section 1	Purpose and Scope
Section 2	Definitions
Section 3	Duties of Producers
Section 4	Duties of Insurers that Use Producers
Section 5	Duties of Replacing Insurers that Use Producers

Section 6	Duties of the Existing Insurer
Section 7	Duties of Insurer with Respect to Direct Response Solicitations
Section 8	Violations and Penalties
Section 9	Severability
Section 10	Effective Date
Appendix A	Important Notice Regarding Replacements
Appendix B	Notice Regarding Replacements for Direct Response Insurers
Appendix C	Important Notice Regarding Replacements for Direct Response Insurers

Table 11.4

EXEMPTIONS TO THE REPLACEMENT MODEL REGULATION

- Credit life insurance;
- Group life insurance or group annuities where there is no direct solicitation of individuals by an insurance producer;
- Group life insurance and annuities used to fund prearranged funeral contracts;
- An application to the existing insurer that issued the existing policy or contract when a contractual change or a conversion privilege is being exercised; or, when the existing policy/contract is being replaced by the same insurer pursuant to a program filed with and approved by the commissioner; or, when a term conversion privilege is exercised among corporate affiliates;
- Proposed life insurance that is to replace life insurance under a binding or conditional receipt issued by the same company;
- Policies or contracts used to fund (i) an employee pension or welfare benefit plan that is covered by the Employee Retirement and Income Security Act (ERISA); (ii) a plan described by Sections 401(a), 401(k) or 403(b) of the Internal Revenue Code, where the plan, for purposes of ERISA, is established or maintained by an employer; (iii) a governmental or church plan defined in Section 414, a governmental or church welfare benefit plan, or a deferred compensation plan of a state or local government or tax exempt organization under Section 457 of the Internal Revenue Code; or (iv) a nonqualified deferred compensation arrangement established or maintained by an employer or plan sponsor.

***Note**:* Notwithstanding the paragraph above, this regulation applies to policies or contracts used to fund any plan or arrangement that is funded solely by contributions an employee elects to make, whether on a pre-tax or after-tax basis, and where the insurer has been notified that plan participants may choose from among two (2) or more insurers and there is a direct solicitation of an individual employee by an insurance producer for the purchase of a contract or policy.

- Where new coverage is provided under a life insurance policy or contract and the cost is borne wholly by the insured's employer or by an association of which the insured is a member;
- Existing life insurance that is a non-convertible term life insurance policy that will expire in five (5) years or less and cannot be renewed;
- Immediate annuities that are purchased with proceeds from an existing contract (immediate annuities purchased with proceeds from an existing policy are not exempted from the requirements of this regulation); or
- Structured settlements.

DEFINITIONS AS USED IN THE CONTEXT OF THE REPLACEMENT MODEL ACT

A. "**Direct Response Solicitation**" means a solicitation through a sponsoring or endorsing entity or individually solely through mailings, telephone, the Internet or other mass communication media.

B. "**Existing Insurer**" means the insurance company whose policy or contract is or will be changed or affected in a manner described within the definition of "replacement."

C. "**Existing policy or contract**" means an individual life insurance policy or annuity contract in force, including a policy under a binding or conditional receipt or a policy or contract that is within an unconditional refund period.

D. "**Financed purchase**" means the purchase of a new policy involving the actual or intended use of funds obtained by the withdrawal or surrender of, or by borrowing from values of an existing policy to pay all or part of any premium due on the new policy. For purposes of a regulatory review of an individual transaction only, if a withdrawal, surrender or borrowing involving the policy values of an existing policy is used to pay premiums on a new policy owned by the same policyholder and issued by the same company within four (4) months before or thirteen (13) months after the effective date of the new policy, it will be deemed prima facie evidence of the

policyholder's intent to finance the purchase of the new policy with existing policy values.

E. "**Illustration**" means a presentation or depiction that includes non-guaranteed elements of a policy of life insurance over a period of years as defined in [insert reference to state law equivalent to the NAIC Life Insurance Illustrations Model Regulation].

F. "**Policy summary**," for the purposes of this regulation:

- For policies or contracts other than universal life policies, means a written statement regarding a policy or contract which shall contain to the extent applicable, but need not be limited to, the following information: current death benefit; annual contract premium; current cash surrender value; current dividend; application of current dividend; and amount of outstanding loan.
- For universal life policies, means a written statement that shall contain at least the following information: the beginning and end date of the current report period; the policy value at the end of the previous report period and at the end of the current report period; the total amounts that have been credited or debited to the policy value during the current report period, identifying each by type (e.g., interest, mortality, expense and riders); the current death benefit at the end of the current report period on each life covered by the policy; the net cash surrender value of the policy as of the end of the current report period; and the amount of outstanding loans, if any, as of the end of the current report period.

G. "**Producer**," for the purpose of this regulation, shall be defined to include agents, brokers and producers.

H. "**Replacing insurer**" means the insurance company that issues or proposes to issue a new policy or contract that replaces an existing policy or contract or is a financed purchase.

I. "**Registered contract**" means an annuity contract or life insurance policy subject to the prospectus delivery requirements of the Securities Act of 1933.

J. "**Replacement**" means a transaction in which a new policy or contract is to be purchased, and it is known or should be known to the proposing producer, or to the proposing insurer if there is no producer, that by reason of the transaction, an existing policy or contract has been or is to be:

- Lapsed, forfeited, surrendered or partially surrendered, assigned to the replacing insurer or otherwise terminated;

- Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
- Amended so as to effect either a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;
- Reissued with any reduction in cash value; or
- Used in a financed purchase.

K. "**Sales material**" means a sales illustration and any other written, printed or electronically presented information created, or completed or provided by the company or producer and used in the presentation to the policy or contract owner related to the policy or contract purchased.

DUTIES OF PRODUCERS

A producer who initiates an application is required to submit to the insurer, with or as part of the application, a statement signed by both the applicant and the producer as to whether the applicant has existing policies or contracts. If the answer is "no," the producer's duties with respect to replacement are complete.

If the applicant answered "yes" to the question regarding such existing coverage, the producer must present and read to the applicant, not later than at the time of taking the application, a notice regarding replacements in the form as described in Appendix A or other substantially similar form approved by the commissioner. However, no approval is required when amendments to the notice are limited to the omission of references not applicable to the product being sold or replaced. The notice must be signed by both the applicant and the producer attesting that the notice has been read aloud by the producer or that the applicant did not wish the notice to be read aloud (in which case the producer need not have read the notice aloud) and left with the applicant.

The notice must list all life insurance policies or annuities proposed to be replaced, properly identified by name of insurer, the insured or annuitant, and policy or contract number if available; and must include a statement as to whether each policy or contract will be replaced or whether a policy will be used as a source of financing for the new policy or contract. If a policy or contract number has not been issued by the existing insurer, alternative identification, such as an application or receipt number, must be listed.

In connection with a replacement transaction, the producer must leave with the applicant (at the time an application for a new policy or contract is completed) the original or a copy of all sales material. With respect to electronically presented sales material, it must be provided to the policy or contract owner in printed form no later than at the time of policy or contract delivery.

Except as provided in Section 5C, in connection with a replacement transaction the producer shall submit to the insurer to which an application for a policy or contract is presented, a copy of each document required by this section, a statement identifying any preprinted or electronically presented company approved sales materials used, and copies of any individualized sales materials, including any illustrations related to the specific policy or contract purchased.

DUTIES OF INSURERS THAT USE PRODUCERS

Insurers are required to maintain a system of supervision and control to insure compliance with the requirements of this regulation that must include at least the following:

- Inform its producers of the requirements of this regulation and incorporate the requirements of this regulation into all relevant producer training manuals prepared by the insurer;
- Provide to each producer a written statement of the company's position with respect to the acceptability of replacements providing guidance to its producer as to the appropriateness of these transactions;
- A system to review the appropriateness of each replacement transaction that the producer does not indicate is in accord with Paragraph (2) above;
- Procedures to confirm that the requirements of this regulation have been met; and
- Procedures to detect transactions that are replacements of existing policies or contracts by the existing insurer, but that have not been reported as such by the applicant or producer. Compliance with this regulation may include, but cannot be limited to, systematic customer surveys, interviews, confirmation letters, or programs of internal monitoring.

The supervisory system must have the capacity to monitor each producer's life insurance policy and annuity contract replacements for that insurer, and must produce, upon request, and make such records available to the Insurance Department. The capacity to monitor must include the ability to produce records for each producer's:

- Life replacements, including financed purchases, as a percentage of the producer's total annual sales for life insurance;
- Number of lapses of policies by the producer as a percentage of the producer's total annual sales for life insurance;
- Annuity contract replacements as a percentage of the producer's total annual annuity contract sales;
- Number of transactions that are unreported replacements of existing policies or contracts by the existing insurer detected by the company's monitoring system; and
- Replacements, indexed by replacing producer and existing insurer.

Insurers must require with or as a part of each application for life insurance or an annuity a signed statement by both the applicant and the producer as to whether the applicant has existing policies or contracts; and require with each application for life insurance or an annuity that indicates an existing policy or contract a completed notice regarding replacements as contained in Appendix A.

When the applicant has existing policies or contracts, each insurer must be able to produce copies of any sales material utilized, the basic illustration and any supplemental illustrations related to the specific policy or contract that is purchased, and the producer's and applicant's signed statements with respect to financing and replacement for at least five (5) years after the termination or expiration of the proposed policy or contract.

Insurers must also:

- Ascertain that the sales material and illustrations meet the requirements of this regulation and are complete and accurate for the proposed policy or contract;
- If an application does not meet the requirements of this regulation, notify the producer and applicant and fulfill the outstanding requirements; and
- Maintain records in paper, photograph, microprocess, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document.

DUTIES OF REPLACING INSURERS THAT USE PRODUCERS

Replacing insurers are required to:

- Verify that the required forms are received and are in compliance with this regulation;

- Notify any other existing insurer that may be affected by the proposed replacement within five (5) business days of receipt of a completed application indicating replacement or when the replacement is identified if not indicated on the application, and mail a copy of the available illustration or policy summary for the proposed policy or available disclosure document for the proposed contract within five (5) business days of a request from an existing insurer;
- Be able to produce copies of the notification regarding replacement required, indexed by producer, for at least five (5) years or until the next regular examination by the insurance department of a company's state of domicile, whichever is later; and
- Provide to the policy or contract owner notice of the right to return the policy or contract within thirty (30) days of the delivery of the contract and receive an unconditional full refund of all premiums or considerations paid on it, including any policy fees or charges or, in the case of a variable or market value adjustment policy or contract, a payment of the cash surrender value provided under the policy or contract plus the fees and other charges deducted from the gross premiums or considerations or imposed under such policy or contract; such notice may be included in Appendix A or C.

In transactions where the replacing insurer and the existing insurer are the same or subsidiaries or affiliates under common ownership or control, allow credit for the period of time that has elapsed under the replaced policy's or contract's incontestability and suicide period up to the face amount of the existing policy or contract. With regard to financed purchases, the credit may be limited to the amount the face amount of the existing policy is reduced by the use of existing policy values to fund the new policy or contract.

If an insurer prohibits the use of sales material other than that approved by the company, as an alternative to the above requirements made of an insurer, the insurer may:

- Require with each application a statement signed by the producer that:
    - Represents that the producer used only company-approved sales material; and
    - States that copies of all sales material were left with the applicant; and
- Within ten (10) days of the issuance of the policy or contract:
    - Notify the applicant by sending a letter or by verbal communication with the applicant by a person whose duties are separate from the marketing

area of the insurer, that the producer has represented that copies of all sales material have been left with the applicant;

  - Provide the applicant with a toll free number to contact company personnel involved in the compliance function if such is not the case; and
  - Stress the importance of retaining copies of the sales material for future reference; and

- Be able to produce a copy of the letter or other verification in the policy file for at least five (5) years after the termination or expiration of the policy or contract.

DUTIES OF THE EXISTING INSURER

Where a replacement is involved in the transaction, the existing insurer must:

- Retain and be able to produce all replacement notifications received, indexed by replacing insurer, for at least five (5) years or until the conclusion of the next regular examination conducted by the Insurance Department of its state of domicile, whichever is later.
- Send a letter to the policy or contract owner of the right to receive information regarding the existing policy or contract values including, if available, an in force illustration or policy summary if an in force illustration cannot be produced within five (5) business days of receipt of a notice that an existing policy or contract is being replaced. The information shall be provided within five (5) business days of receipt of the request from the policy or contract owner.
- Upon receipt of a request to borrow, surrender or withdraw any policy values, send a notice, advising the policy owner that the release of policy values may affect the guaranteed elements, nonguaranteed elements, face amount or surrender value of the policy from which the values are released. The notice shall be sent separate from the check if the check is sent to anyone other than the policy owner. In the case of consecutive automatic premium loans, the insurer is only required to send the notice at the time of the first loan.

DUTIES OF INSURERS WITH RESPECT TO DIRECT RESPONSE SOLICITATIONS

In the case of an application that is initiated as a result of a direct response solicitation, the insurer must require, with or as part of each completed application for a policy or contract, a statement asking whether the applicant, by applying for the

proposed policy or contract, intends to replace, discontinue or change an existing policy or contract. If the applicant indicates a replacement or change is not intended or if the applicant fails to respond to the statement, the insurer must send the applicant, with the policy or contract, a notice regarding replacement in Appendix B, or other substantially similar form approved by the commissioner.

If the insurer has proposed the replacement or if the applicant indicates a replacement is intended and the insurer continues with the replacement, the insurer must provide to applicants or prospective applicants with the policy or contract a notice, as described in Appendix C, or other substantially similar form approved by the commissioner. In these instances the insurer may delete the references to the producer, including the producer's signature, and references not applicable to the product being sold or replaced, without having to obtain approval of the form from the commissioner. The insurer's obligation to obtain the applicant's signature shall be satisfied if it can demonstrate that it has made a diligent effort to secure a signed copy of the notice referred to in this paragraph. The requirement to make a diligent effort shall be deemed satisfied if the insurer includes in the mailing a self-addressed postage prepaid envelope with instructions for the return of the signed notice referred to in this section.

VIOLATIONS AND PENALTIES

Any failure to comply with this regulation will be considered a violation of [cite "twisting" section of state's Unfair Trade Practices Act]. Examples of violations include:

- Any deceptive or misleading information set forth in sales material;
- Failing to ask the applicant in completing the application the pertinent questions regarding the possibility of financing or replacement;
- The intentional incorrect recording of an answer;
- Advising an applicant to respond negatively to any question regarding replacement in order to prevent notice to the existing insurer; or
- Advising a policy or contract owner to write directly to the company in such a way as to attempt to obscure the identity of the replacing producer or company.

Policy and contract owners have the right to replace existing life insurance policies or annuity contracts after indicating in or as a part of applications for new coverage that replacement is not their intention; however, patterns of such action by policy or contract owners of the same producer shall be deemed prima facie evidence of the

producer's knowledge that replacement was intended in connection with the identified transactions, and these patterns of action shall be deemed prima facie evidence of the producer's intent to violate this regulation.

Where it is determined that the requirements of this regulation have not been met the replacing insurer shall provide to the policy owner an in force illustration if available or policy summary for the replacement policy or available disclosure document for the replacement contract and the appropriate notice regarding replacements in Appendix A or C.

Violations of this regulation shall subject the violators to penalties that may include the revocation or suspension of a producer's or company's license, monetary fines and the forfeiture of any commissions or compensation paid to a producer as a result of the transaction in connection with which the violations occurred. In addition, where the commissioner has determined that the violations were material to the sale, the insurer may be required to make restitution, restore policy or contract values and pay interest at [insert reference to a rate set by an applicable statute or regulation] on the amount refunded in cash.

IMPORTANT NOTICE – REPLACEMENT OF LIFE INSURANCE OR ANNUITIES (APPENDIX A)

IMPORTANT NOTICE:
REPLACEMENT OF LIFE INSURANCE OR ANNUITIES
This document must be signed by the applicant and the producer, if there is one, and a copy left with the applicant.

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements before you make your purchase decision and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? ___ YES ___ NO
2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? ___ YES ___ NO

   If you answered "yes" to either of the above questions, list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured or annuitant, and the policy or contract number if available) and whether each policy or contract will be replaced or used as a source of financing:

	INSURER NAME	CONTRACT OR POLICY #	INSURED OR ANNUITANT	REPLACED (R) OR FINANCING (F)
1.				
2.				
3.				

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer. Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

The existing policy or contract is being replaced because _____.

I certify that the responses herein are, to the best of my knowledge, accurate:

_____ _____

Applicant's Signature and Printed Name Date

_____ _____

Producer's Signature and Printed Name Date

I do not want this notice read aloud to me. ____ (Applicants must initial only if they do not want the notice read aloud.)

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS: Are they affordable?
Could they change?
You're older—are premiums higher for the proposed new policy?
How long will you have to pay premiums on the new policy? On the old policy?

POLICY VALUES:	New policies usually take longer to build cash values and to pay dividends. Acquisition costs for the old policy may have been paid, you will incur costs for the new one. What surrender charges do the policies have? What expense and sales charges will you pay on the new policy? Does the new policy provide more insurance coverage?
INSURABILITY:	If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down. You may need a medical exam for a new policy. Claims on most new policies for up to the first two years can be denied based on inaccurate statements. Suicide limitations may begin anew on the new coverage.
IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:	
	How are premiums for both policies being paid? How will the premiums on your existing policy be affected? Will a loan be deducted from death benefits? What values from the old policy are being used to pay premiums?
IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:	
	Will you pay surrender charges on your old contract? What are the interest rate guarantees for the new contract? Have you compared the contract charges or other policy expenses?
OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:	
	What are the tax consequences of buying the new policy? Is this a tax free exchange? (See your tax advisor.) Is there a benefit from favorable "grandfathered" treatment of the old policy under the federal tax code? Will the existing insurer be willing to modify the old policy? How does the quality and financial stability of the new company compare with your existing company?

Table 11.5, NAIC Life Insurance and Annuities Replacement Model Regulation, Appendix A

NOTICE REGARDING REPLACEMENT – REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY? (APPENDIX B)

NOTICE REGARDING REPLACEMENT
REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one—or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed policy or contract's benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy or contract to give you information about it. Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.
Table 11.6, NAIC Life Insurance and Annuities Replacement Model Regulation, Appendix B

IMPORTANT NOTICE – REPLACEMENT OF LIFE INSURANCE OR ANNUITIES (APPENDIX C)

Appendix C nearly mirrors Appendix A, yet there are a few differences to note.

IMPORTANT NOTICE:
REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements before you make your purchase decision and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? ___ YES ___ NO
2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? ___ YES ___ NO

   Please list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured or annuitant, and the policy or contract number if available) and whether each policy or contract will be replaced or used as a source of financing:

	INSURER NAME	CONTRACT OR POLICY #	INSURED OR ANNUITANT	REPLACED (R) OR FINANCING (F)
1.				
2.				
3.				

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer. Ask for and retain

all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

I certify that the responses herein are, to the best of my knowledge, accurate:

_____ _____

Applicant's Signature and Printed Name Date

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS:
Are they affordable?
Could they change?
You're older—are premiums higher for the proposed new policy?
How long will you have to pay premiums on the new policy? On the old policy?

POLICY VALUES:
New policies usually take longer to build cash values and to pay dividends.
Acquisition costs for the old policy may have been paid, you will incur costs for the new one.
What surrender charges do the policies have?
What expense and sales charges will you pay on the new policy?
Does the new policy provide more insurance coverage?

INSURABILITY:
If your health has changed since you bought your old policy, the new one could cost you more,
or you could be turned down.
You may need a medical exam for a new policy.
Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
Suicide limitations may begin anew on the new coverage.

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:

How are premiums for both policies being paid?
How will the premiums on your existing policy be affected?
Will a loan be deducted from death benefits?
What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:

Will you pay surrender charges on your old contract?
What are the interest rate guarantees for the new contract?
Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:

	What are the tax consequences of buying the new policy? Is this a tax free exchange? (See your tax advisor.) Is there a benefit from favorable "grandfathered" treatment of the old policy under the federal tax code? Will the existing insurer be willing to modify the old policy? How does the quality and financial stability of the new company compare with your existing company?

Table 11.7, NAIC Life Insurance and Annuities Replacement Model Regulation, Appendix C

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY

FINRA, the Financial Industry Regulatory Authority, is the non-governmental regulator for all securities firms doing business in the United States. FINRA is a nonprofit organization authorized by Congress to protect America's investors by making sure the broker-dealer industry operates fairly and honestly.

FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering the largest dispute resolution forum for investors and registered firms.

FINRA also performs market regulation under contract for the NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange. FINRA operates from Washington, DC, and New York City, with various district offices around the country.

FINRA investigates potential securities violations and, when appropriate, brings formal disciplinary actions against firms and their associated persons. FINRA investigations may be opened from various sources, including automated surveillance reports, examination findings, filings made with FINRA, customer complaints, tips, referrals from other regulators or other FINRA departments and press reports.

If it appears that rules have been violated, Enforcement will determine whether the conduct merits formal disciplinary action. FINRA can take disciplinary action through two separate procedures—a settlement or a litigated proceeding. With a settlement, the respondent can opt to resolve alleged rule violations early by submitting a Letter of Acceptance, Waiver and Consent (AWC). Otherwise, FINRA may issue a formal complaint to FINRA's Office of Hearing Officers (OHO). If the respondent does not

settle the complaint, the matter proceeds to a contested hearing before OHO, which hears the case and issues a decision.

Enforcement also brings disciplinary cases on behalf of the securities exchanges with which it has entered into Regulatory Services Agreements (RSAs). These matters may be brought on behalf of a single exchange or, more commonly, may be brought as global settlements on behalf of multiple self-regulatory organizations, sometimes including FINRA.

Sanctions for wrongdoing include fines, suspensions, and, in cases of serious misconduct, bars from the brokerage industry. FINRA publishes its Sanction Guidelines so that members, associated persons and their counsel understand the types of disciplinary sanctions that may be applicable to various violations. Whenever possible, Enforcement orders firms and individuals to make restitution to harmed customers.

Not all investigations result in formal disciplinary action. For example, if the violation is of a minor nature and there is an absence of customer harm or detrimental market impact, the matter may be resolved with an informal disciplinary action, such as the issuance of a Cautionary Action. While Cautionary Actions are considered by the staff in any future disciplinary matter, these actions do not constitute formal discipline and are not reportable on FINRA's Central Registration Depository (CRD) system.

In addition, Enforcement may determine not to recommend formal disciplinary action following an investigation and may close the matter without further action.

CONCERNS OVER SUITABILITY OF VARIABLE ANNUITY SALES

Variable annuities have evolved into a fairly sophisticated securities vehicle with a combination of security and insurance features. In the face of growing product complexity, regulators have been concerned about the suitability of variable annuity sales.

FINRA RULE 2330 SUPERSEDES NASD RULE 2821

FINRA adopted NASD Rule 2821 in response to its perception of “numerous instances of questionable sales practices” and inadequate supervision and training procedures regarding variable annuities. On November 20, 2009, FINRA filed with the Securities and Exchange Commission (SEC) a proposed rule change, for immediate effectiveness, to transfer NASD Rule 2821 into the Consolidated FINRA Rulebook, as FINRA Rule 2330, without any substantive changes. NASD Rule 2821

has been superseded by FINRA Rule 2330, with an applicable date of February 8, 2010.

FINRA Rule 2330 establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities. The rule has the following six main sections:

- General considerations, such as the rule's applicability;
- Recommendation requirements, including suitability and disclosure obligations;
- Principal review and approval obligations;
- Requirements for establishing and maintaining supervisory procedures;
- Training obligations; and
- Supplementary material that addresses a variety of issues ranging from the handling of customer funds and checks to information gathering and sharing
- Principal review and approval,
- Supervisory procedures, and
- Training.

Questions had been raised regarding FINRA's limited interpretive relief from the requirements of FINRA Rule 2150(a) (formerly NASD Rule 2330(a)) and FINRA Rule 2320(d) (formerly NASD Rule 2820(d)).[43] The former rule generally prohibits firms from making improper use of customer funds, and the latter requires firms to transmit promptly to issuers applications and purchase payments for variable contracts. FINRA provided limited interpretive relief from these rules to allow firms to perform comprehensive and rigorous reviews of recommended transactions in deferred variable annuities under FINRA Rule 2330.

FINRA originally stated that "a firm may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven business days without violating either NASD Rule 2330 or 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to NASD Rule 2821." After the SEC approved amendments that changed the starting point for the review period—from the date when the customer signs the application to the date when a firm's office of supervisory jurisdiction (OSJ) receives a complete and correct application package—FINRA explained that its limited

[43] FINRA Regulatory Notice 07-53, Nov. 2007; Regulatory Notice 09-32, June 2009

interpretive relief “continues to apply even though the triggering event for the principal review period has changed via the recently approved amendments.[44]

Concerns had been expressed, however, regarding the breadth of the interpretive relief and the conditions that must be present for it to apply. FINRA clarified that the interpretive relief applies only if the seven conditions delineated below are present.

1. The reason that the firm is holding the application for a deferred variable annuity and/or a customer's non-negotiated check payable to a third party is to allow completion of principal review of the transaction pursuant to FINRA Rule 2330.

2. The associated person who recommended the purchase or exchange of the deferred variable annuity makes reasonable efforts to safeguard the check and to promptly prepare and forward a complete and correct copy of the application package to an office of supervisory jurisdiction.

3. The firm has policies and procedures in place that are reasonably designed to ensure that the check is safeguarded and that reasonable efforts are made to promptly prepare and forward a complete and correct copy of the application package to an office of supervisory jurisdiction.

4. A principal reviews and makes a determination of whether to approve or reject the purchase or exchange of the deferred variable annuity in accordance with the provisions of FINRA Rule 2330.

5. The firm holds the application and/or check no longer than seven business days from the date an office of supervisory jurisdiction receives a complete and correct copy of the application package.

6. The firm maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company or returned to the customer.

7. The firm creates a record of the date when the office of supervisory jurisdiction receives a complete and correct copy of the application package.

If these seven conditions are not present, FINRA's interpretive relief will not apply and it will enforce FINRA Rules 2150(a) and 2320(d), as appropriate.

The SEC provided a conditional exemption for broker-dealers from any additional requirements of Rules 15c3-1 and 15c3-3 due solely to a failure to promptly transmit

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[44] FINRA Regulatory Notice 07-53, Nov. 2007; Regulatory Notice 09-32, June 2009

a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker-dealer receives the check from the customer, provided (i) the transaction is subject to the principal review requirements of NASD Rule 2821 and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with that rule; (ii) the broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and (iii) the broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved, or returned to the customer if rejected. In its order approving recent amendments, the SEC explained that the exemption order continues to apply, notwithstanding the new starting point for the principal review period under NASD Rule 2821.[45]

FINRA emphasizes that firms are not required to collect and hold checks or funds prior to principal review and approval. A firm may elect to wait until after a principal approves the transaction to collect the check or funds for a deferred variable annuity. Moreover, a firm can forward a check made payable to the insurance company or, if the firm is fully subject to SEA Rule 15c3-3, transfer "funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements:

(a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and

(b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will:

(1) segregate the member's customers' funds in a 'Special Account for the Exclusive Benefit of Customers' (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold

[45] FINRA Exchange Act Release No. 59772, April 20090

those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers,

(2) not issue the variable annuity contract prior to the member's principal approval, and

(3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application."

RESPONSIBILITIES REGARDING DEFERRED VARIABLE ANNUITIES

2330. Members' Responsibilities Regarding Deferred Variable Annuities

GENERAL CONSIDERATIONS – APPLICATION OF FINRA RULE 2330

(a) General Considerations (1) Application. This Rule applies to recommended purchases and exchanges of deferred variable annuities and recommended initial subaccount allocations. This Rule does not apply to reallocations among subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

CREATION, STORAGE, AND TRANSMISSION OF DOCUMENTS

(2) Creation, Storage, and Transmission of Documents. For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

"REGISTERED PRINCIPAL" AS USED IN THE RULE

(3) Definitions. For purposes of this Rule, the term "**registered principal**" shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24) or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

RECOMMENDATION REQUIREMENTS

(b) Recommendation Requirements. (1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with NASD Rule 2310 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as

death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph must be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(3) Promptly after receiving information necessary to prepare a complete and correct application package for a deferred variable annuity, a person associated with a member who recommends the deferred variable annuity shall transmit the complete and correct application package to an office of supervisory jurisdiction of the member.

PRINCIPAL REVIEW AND APPROVAL

(c) Principal Review and Approval. Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but **no later than seven business days** after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.

The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction.

SUPERVISORY PROCEDURES

(d) Supervisory Procedures. In addition to the general supervisory and recordkeeping requirements of NASD Rules 3010, 3012, and 3110, and Rule 3130, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

TRAINING PROGRAMS

(e) Training. Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in paragraph (b)(1)(A)(i) of this Rule.

DEPOSITING OF FUNDS PRIOR TO APPROVAL

.01 Depositing of Funds by Members Prior to Principal Approval. Under Rule 2330, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

TREATMENT OF LUMP SUM PAYMENTS

.02 Treatment of Lump Sum Payments for Purchases of Different Products. If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be

applied to other types of products, Rule 2330 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

Forwarding Funds to Insurer Prior to Approval

.03 Forwarding of Checks/Funds to Insurer Prior to Principal Approval. Rule 2330 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

Forwarding Funds to IRA Custodian Prior to Approval

.04 Forwarding of Checks/Funds to IRA Custodian Prior to Principal Approval. A member is not prohibited from forwarding a check provided by the customer for the purpose of purchasing a deferred variable annuity and made payable to an IRA custodian for the benefit of the customer (or, if the member is fully subject to SEA Rule 15c3-3, funds) to the IRA custodian prior to the member's principal approval of the deferred variable annuity transaction, as long as the member enters into a written

agreement with the IRA custodian under which the IRA custodian agrees (a) to forward the funds to the insurance company to complete the purchase of the deferred variable annuity contract only after it has been informed that the member's principal has approved the transaction and (b), if the principal rejects the transaction, to inform the customer, seek immediate instructions from the customer regarding alternative disposition of the funds (e.g., asking whether the customer wants to transfer the funds to another IRA custodian, purchase a different investment, or provide other instructions), and promptly implement the customer's instructions.

CONSUMER EXCHANGES

.05 Gathering of Information Regarding Customer Exchanges. Rule 2330 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

SHARING OF OFFICE SPACE AND/OR EMPLOYEES

.06 Sharing of Office Space and/or Employees. Rule 2330 requires principal review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing...." In circumstances where an insurance company and its affiliated broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

INFORMATION SHARING

.07 Sharing of Information. Rule 2330 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company

will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

Variable annuity contracts must be reviewed by a registered principal within seven business days after application

RECENT DISCIPLINARY ACTIONS

FINRA has taken disciplinary actions against the following firms and individuals for violations of FINRA rules; federal securities laws; rules and regulations; and the rules of the Municipal Securities Rulemaking Board (MSRB).

FIRMS FINED, INDIVIDUALS SANCTIONED

Lek Securities Corporation (CRD #33135, New York, New York) and Samuel Frederik Lek (CRD #1642936, New York, New York), December 20, 2019

An Offer of Settlement was issued in which the firm was suspended from selling or accepting for deposit any low-priced security until it certifies to FINRA that it has implemented the recommendations of an independent consultant, fined $200,000 and required to retain one or more qualified independent consultants to conduct a comprehensive review of its supervisory system and its compliance with anti-money laundering (AML) and Section 5 of the Securities Act of 1933 obligations in connection with stock trading in low-priced securities. Samuel Lek was not separately sanctioned herein because he was barred in FINRA Case #2012029713004.

Without admitting or denying the allegations, the firm and Samuel Lek consented to the sanctions and to the entry of findings that they failed to implement AML policies, procedures and internal controls reasonably expected to detect and cause the reporting of suspicious transactions and reasonably designed to achieve compliance with the Bank Secrecy Act, and the implementing regulations promulgated thereunder, by the Department of the Treasury. The findings stated that the activity resulted in microcap trades being conducted without reasonable detection, investigation and determination as to whether such transactions should be reported

on a suspicious activity report (SAR). The findings also stated that as the firm's AML compliance officer, chief executive officer (CEO) and chief compliance officer (CCO), Samuel Lek was responsible for its supervisory system, including its certificate review process. The firm and Samuel Lek failed to supervise for compliance with Section 5 of the Securities Act by failing to establish reasonable written supervisory procedures (WSPs) to fulfill its obligations to conduct a searching inquiry, prior to liquidating microcap securities, to determine whether the customer's resale of those shares was registered or subject to an exemption from registration. The firm, acting under Samuel Lek's direction, also failed to conduct reasonable due diligence on the deposits, customers and issuers despite red flags that existed at the time of deposit or trading of microcap securities. The findings also included that the firm acted in contravention of Section 5 of the Securities Act by engaging in the sales of unregistered securities in transactions not subject to an exemption from registration requirements. In total, firm accounts liquidated microcap stocks and generated approximately $100 million of proceeds, for which the firm received approximately $1.6 million in commissions. FINRA found that the firm failed to conduct timely reviews of Financial Crimes Enforcement Network (FinCen) 314(a) information requests. The firm failed to access the FinCen online portal to conduct mandated searches. FINRA also found that the firm failed to conduct reasonable testing of its AML program. The firm engaged various third parties to conduct its responsibilities to supervise trading and ensure compliance with Reg SHO. Barkley did not ensure that the representative was acting as a bona-fide market maker and was otherwise complying with Reg SHO. Although Barkley monitored the representative's trading in the stocks in real time and communicated frequently with him, Barkley did not regularly monitor the market maker quotes the representative was displaying to the market at the time of his trading. Consequently, Barkley failed to detect quotations in the stocks that were far away from competitive levels on either the buy or sell side. Barkley assumed that all of the representative's short selling in the security was a part of bona-fide market making and simply signed off on his market maker applications. Barkley was not concerned whether the representative's quotations were consistent with genuine market making, but rather the concern lay in the exposure and potential loss that his trading in the low-priced stocks created for the firm. Further, the firm, acting through Snow, failed to assign each registered person at the firm to an appropriately registered principal or representative that would be responsible for supervising that person's activities. As a result, the firm and Snow failed to implement a reasonable supervisory system to supervise the representatives and principals at the firm. In addition, Snow and the firm created a heightened supervision plan for a representative that was untimely and insufficient. Snow was obligated to appropriately document decisions made with respect to heightened supervision; however, he and the firm did nothing. The firm and Snow also failed to

reasonably supervise instant message communications of the firm's representatives. Snow delegated the review of instant messages by the representatives to an unregistered person at the firm and failed to take reasonable steps to ensure that the delegated function was executed properly. The findings also included that the firm and Snow failed to establish and implement reasonable AML policies and procedures to detect, investigate and report, where appropriate, suspicious trading activity by filing an SAR. Snow was responsible for ensuring that the firm's AML program was adequately tailored to the risks posed by the firm's business activities and establishing an AML program to mitigate those risks. In addition, the firm and Snow failed to provide adequate AML training to firm staff.

These sanctions are not in effect pending review.[46]

FIRMS FINED

Apex Clearing Corporation (CRD #13071, Dallas, Texas), December 31, 2019

An AWC was issued in which the firm was censured, fined $250,000 and required to provide a written certification within 90 days that it has completed a review of its systems and procedures regarding SEC Rule 10b-16(a)(1), and as of the date of the certification, the firm's policies, systems and procedures are reasonably designed to achieve compliance with the rule. Without admitting or denying the findings, the firm consented to the sanctions and to the entry of findings that it failed to establish procedures reasonably designed to ensure that introduced customers received initial margin interest rate disclosures and failed to establish, maintain, and enforce a supervisory system, including WSPs, reasonably designed to achieve compliance with SEC Rule 10b-16(a)(1). The findings stated that the firm provided its introducing firms with a Margin Disclosure Statement document, which it understood its introducing firms provided to customers prior to the firm opening a margin account for the customer. While the firm had a process in place to ensure that the Margin Disclosure Statement was provided by the introducing firm, the statement did not disclose the introducing firm-specific margin interest rate. Some of the firm's introducing firms did not make margin interest rate disclosures at the time of account opening. As the broker extending credit, the firm was responsible for establishing procedures to ensure that the margin rates were disclosed to customers at the time they opened margin accounts. The firm did not have procedures to ensure that introduced customers received margin interest disclosures at the time of account

[46] FINRA Case #2012032731802

opening. Certain customers of the firm's introducing firms did not receive the initial disclosure stating the annual rate or rates of margin interest that could be imposed.[47]

INACCURACIES AND NONCOMPLIANCE

Dash Financial Technologies LLC (CRD #104031, Chicago, Illinois), January 2, 2020

A Letter of Acceptance, Waiver and Consent (AWC) was issued in which the firm was censured and fined $90,000. Without admitting or denying the findings, the firm consented to the sanctions and to the entry of findings that it transmitted inaccurate Reportable Order Events (ROEs) to the Order Audit Trail System (OATS™), primarily due to the failure to append the correct special handling code to directed orders. The findings stated that these inaccuracies resulted from various causes, including the firm's misunderstandings of the application of certain codes, logic flaws within its own systems, logic flaws within a third-party execution and order management system and the misclassification of a consumer account. The findings also stated that the firm's supervisory system was not reasonably designed to achieve compliance with respect to applicable securities laws and regulations, and FINRA rules, concerning OATS. The firm's supervisory system focused on correcting OATS issues that either impacted the ability to submit ROEs or were identified by FINRA, but was not reasonably designed to identify situations in which ROEs contained inaccurate information that would not result in rejects, mismatches, out-of-sequence events, etc. In this regard, while the firm reviewed a small number of orders on a monthly and semi-annual basis to ensure the ROEs submitted for those orders were accurate, the number of orders reviewed was unreasonably small and not tailored to its business activity. As a result of its supervisory failures, the firm was unaware of its inaccurate OATS submissions until notified by FINRA.[48]

FAILURE TO DISCLOSE

Merrill Lynch, Pierce, Fenner & Smith Incorporated (CRD #7691), New York, New York, January 3, 2020

An AWC was issued in which the firm was censured and fined $150,000. Without admitting or denying the findings, the firm consented to the sanctions and to the entry of findings that it executed municipal securities transactions with customers in an amount below an issue's minimum denomination without an exception. The findings stated that the firm provided evidence to FINRA that it offered to rescind the

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[47] FINRA Case #2-10-71642801

[48] FINRA Case #201605051474801

transactions to all of the customers that continued to hold the position. The findings also stated that the firm failed to disclose to its customers all material facts concerning municipal securities transactions at or prior to the time of trade. Specifically, the firm failed to inform its customers, orally or in writing, that the municipal securities transactions were in an amount below the issue's minimum denomination and that this may adversely affect the position's liquidity.[49]

COMMINGLING

John Joseph Cahill (CRD #1240551, Mahwah, New Jersey), January 2, 2020

An AWC was issued in which Cahill was barred from association with any FINRA member in all capacities. Without admitting or denying the findings, Cahill consented to the sanction and to the entry of findings that he refused to provide documents and information and to appear and provide on-the-record testimony requested by FINRA in connection with an investigation into allegations that he commingled and/or converted funds belonging to, and served as power-of-attorney for, an elderly individual who was his customer while he was associated with his former member firm.[50]

FAILURE TO PERFORM REASONABLE BASIS SUITABILITY ANALYSIS

Robert James D'Andria (CRD #1916172, Manasquan, New Jersey), January 3, 2020

An AWC was issued in which D'Andria was fined $5,000 and suspended from association with any FINRA member in all capacities for two months. Without admitting or denying the findings, D'Andria consented to the sanctions and to the entry of findings that he recommended the purchase of non-traditional exchange traded products (NT-ETPs) to customers without having a sufficient understanding of the risks and features associated with these products and thereby failed to have a reasonable basis to make these recommendations. The findings stated that D'Andria failed to perform a reasonable basis suitability analysis of NT-ETPs to understand the unique features and specific risks associated with these products before offering them to his customers. Moreover, D'Andria did not understand that losses in NT-ETPs are compounded because of how the valuations reset each day. The findings also stated that D'Andria's customers held these positions for extended holding periods and as a result, incurred approximately $93,000 in losses. D'Andria's member firm consented to supervision charges in relation to his unsuitable

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[49] FINRA Case #2016049250601

[50] FINRA Case #2019061661601

recommendations of NT-ETPs and agreed to a fine and order of restitution to be paid to the affected customers.

The suspension is in effect from February 3, 2020, through April 2, 2020.[51]

FINRA SUITABILITY IN VARIABLE ANNUITY RECOMMENDATIONS

Variable annuities have evolved into a fairly sophisticated securities vehicle with a combination of security and insurance features. In the face of growing product complexity, regulators have been concerned about the suitability of variable annuity sales.

FINRA, the Financial Industry Regulatory Authority, is the non-governmental regulator for all securities firms doing business in the United States. FINRA is a nonprofit organization authorized by Congress to protect America's investors by making sure the broker-dealer industry operates fairly and honestly.

FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms, writing rules, enforcing those rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering the largest dispute resolution forum for investors and registered firms.

FINRA also performs market regulation under contract for the NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange. FINRA operates from Washington, D.C., and New York City, with various district offices around the country.

FINRA RULE 2111 – SUITABILITY

(FINRA Rule 2310 has been superseded by FINRA Rule 2111.)

Suitability obligations are critical to ensuring investor protection and promoting fair dealings with customers and ethical sales practices. FINRA Rule 2111 governs general suitability obligations, while certain securities are covered under other rules that may contain additional requirements.

[51] FINRA Case #2017056579502

The rule requires that a firm or associated person have a reasonable basis to believe a recommended transaction or investment strategy involving a security or securities is suitable for the customer. This is based on the information obtained through reasonable diligence of the firm or associated person to ascertain the customer's investment profile.

The rule states that the customer's investment profile "includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs [and] risk tolerance," among other information. A "recommendation," which is based on the facts and circumstances of a particular case, is the triggering event for application of the rule.

Brokers must have a firm understanding of both the product and the customer, according to Rule 2111. The lack of such an understanding itself violates the suitability rule.

Rule 2111 lists the three main suitability obligations for firms and associated persons.

- **Reasonable-basis suitability** — Requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. Reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards of the recommended security or strategy.
- **Customer-specific suitability** — Requires that a broker, based on a particular customer's investment profile, has a reasonable basis to believe that the recommendation is suitable for that customer. The broker must attempt to obtain and analyze a broad array of customer-specific factors to support this determination.
- **Quantitative suitability** — Requires a broker with actual or de facto control over a customer's account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, is not excessive and unsuitable for the customer when taken together in light of the customer's investment profile.

2111. Suitability Rule

(a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the

customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in Rule 4512(c), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decision making authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

SUPPLEMENTARY MATERIAL

Supplementary Material .01 General Principles. Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

DISCLAIMERS

.02 Disclaimers. A member or associated person cannot disclaim any responsibilities under the suitability rule.

RECOMMENDED STRATEGIES

.03 Recommended Strategies. The phrase "investment strategy involving a security or securities" used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities. However, the following communications are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

(a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;

(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with Rule 2214 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by Rule 2214; and

(d) Interactive investment materials that incorporate the above.

CUSTOMER'S INVESTMENT PROFILE

.04 Customer's Investment Profile. A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

COMPONENTS OF SUITABILITY OBLIGATIONS

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

(b) The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).

(c) Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

CUSTOMER'S FINANCIAL ABILITY

.06 Customer's Financial Ability. Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

INSTITUTIONAL INVESTOR EXEMPTION

.07 Institutional Investor Exemption. Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or

associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

FINRA RULE 2330 – DEFERRED VARIABLE ANNUITIES

This Rule applies to recommended purchases and exchanges of deferred variable annuities and recommended initial subaccount allocations. This Rule does not apply to reallocations among subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax qualified, employer sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the Exchange Act or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

The term "**registered principal**" means a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24) or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

RECOMMENDATION REQUIREMENTS

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with Rule 2111 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer's age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(3) Promptly after receiving information necessary to prepare a complete and correct application package for a deferred variable annuity, a person associated with a member who recommends the deferred variable annuity shall transmit the complete and correct application package to an office of supervisory jurisdiction of the member.

Principal Review and Approval

Prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.

The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction.

Supervisory Procedures

Firms must also implement special compliance procedures designed to determine if their registered representatives are engaging in excessive switching, and must adopt policies and procedures designed to implement “corrective measures” with respect to inappropriate exchanges and the conduct of representatives who engage in those transactions.

In addition to the general supervisory and recordkeeping requirements of Rules 3110, 3120, 3130, 3150, and 4510 Series, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

Training Programs

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the

requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in paragraph (b)(1)(A)(i) of this Rule.

Depositing Funds Prior to Principal Approval

Under Rule 2330, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

Lump Sum Payments for Purchases of Different Products

If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be applied to other types of products, Rule 2330 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

Forwarding Funds to Insurer Prior to Principal Approval

Rule 2330 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such

funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

Forwarding Funds to IRA Custodian Prior to Principal Approval

A member is not prohibited from forwarding a check provided by the customer for the purpose of purchasing a deferred variable annuity and made payable to an IRA custodian for the benefit of the customer (or, if the member is fully subject to SEA Rule 15c3-3, funds) to the IRA custodian prior to the member's principal approval of the deferred variable annuity transaction, as long as the member enters into a written agreement with the IRA custodian under which the IRA custodian agrees (a) to forward the funds to the insurance company to complete the purchase of the deferred variable annuity contract only after it has been informed that the member's principal has approved the transaction and (b), if the principal rejects the transaction, to inform the customer, seek immediate instructions from the customer regarding alternative disposition of the funds (e.g., asking whether the customer wants to transfer the funds to another IRA custodian, purchase a different investment, or provide other instructions), and promptly implement the customer's instructions.

Information Gathering Regarding Customer Exchanges

Rule 2330 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

Sharing Office Space and/or Employees

Rule 2330 requires principal review and approval "[prior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing…." In circumstances where an insurance company and its affiliated

broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

INFORMATION SHARING

Rule 2330 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

THE BEST INTEREST STANDARD

Regarding these suitability rules, the standard is that any advice given must be **suitable** for the consumer. The Department of Labor introduced new legislation*, the Fiduciary Rule*, that was intended to become effective in 2016. Under the DOL Fiduciary Rule, advice must not only be suitable, but must also be in the "**client's best interest**." Due to legal rulings, the DOL Fiduciary Rule has been deemed ineffective. However, a growing number of states are looking at passing their own legislation that requires a best interest standard, such as New York's Regulation 187.

PRODUCT SPECIFIC TRAINING

For some time, regulators stressed the need for specialized variable annuity training. They are concerned that the registered representatives who sell these complex products do not fully understand them, and cannot properly explain them to their customers. In addition, while many variable annuity contracts share common features, there are significant differences among the products, most of which offer a variety of add-on riders that customers may choose to purchase.

SUITABILITY DOCUMENTATION

Before an annuity transaction is recommended, the agent or the insurer (if no agent is involved) must document, in writing, a reasonable basis for making the recommendation.

For each variable annuity sale or exchange, written documentation must be completed that supports the following:

- Efforts to gather sufficient information from the customer;
- The basis for their belief that the variable annuity and the initial subaccount allocations are suitable for the consumer, including a description of particular features and benefits; and
- For exchanges, the basis for concluding that the transaction is suitable for the consumer in light of any surrender charge in the existing contract, any new surrender period in the new contract, and any benefits lost in the existing contract.

The annuity that is being purchased as part of the replacement transaction will most likely have surrender charges and the consumer needs to understand how these work.

If the consumer will experience a surrender charge as they exit the annuity that is being used as a source of funds for the transaction, the amount of the surrender charge should be disclosed to the consumer. The consumer should consult with their current insurer to see if changes are available within the existing annuity that meet the requirements they seek in a new annuity.

CAPABILITY TO EVALUATE INVESTMENT RISK

A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make his/her own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

- Any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;
- The presence or absence of a pattern of acceptance of the member's recommendations;

- The use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- The extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

Members are reminded that these factors are merely guidelines which will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability.

Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

For purposes of this interpretation, an institutional customer shall be any entity other than a natural person. In determining the applicability of this interpretation to an institutional customer, the Association will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While this interpretation is potentially applicable to any institutional customer, the guidance contained herein is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management.

ANNUITY EXCHANGES AND SUITABILITY

If the variable annuity transaction involves a 1035 exchange, the insurer/agent must consider (and disclose to the consumer in writing) if the customer (as part of the overall transaction) is going to experience a surrender charge and/or incur a new surrender period, lose existing benefits, or be subject to increased fees or charges such as mortality and expense fees.

The agent must also have a reasonable basis for believing that the exchange will benefit the consumer. In addition, extra consideration and due diligence must be given if the customer has had another deferred variable annuity exchange within the preceding **36 months**.

If a customer is exchanging an existing annuity for a new annuity, a comparison between the contracts must be performed. This comparison and disclosure involves

revealing relevant facts about both the current annuity and the proposed annuity; the agent should contrast and compare each feature and benefit, item by item.

All benefits of each annuity, including riders, options, and endorsements, should be disclosed and compared. Rarely will any two annuities be identical in benefits, so the comparison will not always be symmetrical and will demonstrate benefits in one contract that do not exist in the other and vice versa.

With many of the benefits offered by annuities, it is difficult to quantify (in dollar terms) the value of each benefit, and often the consumer has to make a value judgment based on their understanding of the benefit as it applies to them. As an insurance agent you can assist the consumer by disclosing all relevant information in a fair and straightforward manner.

KEY POINTS TO PONDER

- The revisions to NAIC Suitability in Annuity Transactions Model Regulation include a new “best interest” standard, requiring agents and insurers to act with reasonable diligence, care, and skill in making recommendations.
- FINRA Rule 2330 supersedes NASD Rule 2821 (Suitability Rule).
- FINRA Rule 2330 establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities and recommended initial subaccount allocations; requires extra consideration and due diligence for a consumer who has had another annuity exchange within the preceding 36 months
- No later than seven business days after the office of supervisory jurisdiction receives a completed variable annuity contract, the recommendation must be approved or disapproved by a registered principal.

CHAPTER 11 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. The revisions to NAIC Suitability in Annuity Transactions Model Regulation (#275) include a new "_____" standard.

   a) best interest
   b) competency
   c) commission
   d) sales

2. The revisions to NAIC Suitability in Annuity Transactions Model Regulation (#275) requires agents and carriers to act with "_____" in making recommendations.

   a) concern
   b) compelling spirit
   c) reasonable diligence, care and skill
   d) enhancement

3. FINRA Rule 2330 supersedes which Rule?

   a) NAIC Life Guaranty Association
   b) NAIC Health Guaranty Association
   c) NAIC Life & Health Guaranty Association
   d) NASD Rule 2821

CHAPTER 12

DETERMINING CONSUMER SUITABILITY IN ANNUITY SALES

So far we have learned that as a producer selling annuities of any kind, we must obtain information from the prospective customer to ascertain suitability. We have also reviewed the NAIC Annuity Suitability Model Regulation. These regulations spell out the duties of insurers and producers relative to recommendations to consumers for annuity transactions (purchases or exchanges).

Before an annuity transaction is recommended, the agent or the insurer must document in writing a reasonable basis for making the recommendation.

The NAIC Suitability in Annuity Transactions Model Regulation defines categories of "Suitability Information" that should be collected to determine the suitability of a recommended annuity transaction. Most of the suitability forms that have been and will be developed revolve around these twelve categories of information.

- (1) Age
- (2) Annual income
- (3) Financial situation and needs, including the financial resources used for the funding of the annuity
- (4) Financial experience
- (5) Financial objectives
- (6) Intended use of the annuity
- (7) Financial time horizon
- (8) Existing assets, including investment and life insurance holdings
- (9) Liquidity needs
- (10) Liquid net worth
- (11) Risk tolerance
- (12) Tax status

With these in mind, we will now cover many elements of a consumer's lifestyle that can affect the suitability of an annuity transaction. If the producer transacts business in a state with a mandated form or transacts business for an insurer with their own information gathering requirements, we recommend they follow those requirements.

How Annuity Provisions Affect Consumers

As we cover the different categories of information to be gathered from the prospective annuity owner, we will attempt to explain why this information is important and how provisions within an annuity contract can affect a consumer based on differing scenarios.

Since annuities impose surrender charges the current and future liquid resources and needs of the consumer should be a major consideration in determining annuity suitability.

While most regulations affecting annuity suitability do not require all of the below information to be collected, we list many facets of the consumer's current situation that can have a bearing on suitability and provide a short narrative of how and why it is important.

Whether or not the agent decides to embrace all of the suggestions in this section, what is certain is that the more accurate, relevant information one obtains from the consumer, the more likely one is to consistently make suitable recommendations.

Overselling

A big issue with annuity sales is overselling an annuity. Overselling is taking a situation where an annuity makes sense for the consumer but the agent recommends that too much of their assets be put into an annuity. When an annuity is oversold, consumers often find themselves needing cash for some reason and the only place they can turn (short of borrowing) is the annuity, which may still be within the surrender charge period.

Personal Information

This category includes information such as name, age, sex, address, marital status and dependents and their ages. This information should be collected on all parties to the annuity contract.

Consumer's Financial Status

The consumer's current financial situation includes information related to their current assets, income tax circumstances, liquidity needs, and resources.

Assets – Investments and Life Insurance

Information should be collected about all of their investments. For each asset the type of asset, value, original purchase date, intended use, tax status (qualified or nonqualified), type of ownership (single, joint, trust), and current income (if any) provided by the asset.

Endowments

If the consumer is the beneficiary of an endowment, the start date (or maturity/endowment date), the form and amount of payment will be important to determining their future financial outlook. Conversely, if the consumer wishes to fund an endowment for the benefit of others, the desired contribution amount and date of contribution will need to be considered in their overall future financial considerations.

Annual Income and Income Sources

The consumer's income and sources of income need to be determined. Some retirement plans and financial institutions will withhold estimated taxes as a convenience for the income recipient. If the income stream has already had estimated taxes withheld, then the agent needs to know if the amounts withheld have been adequate in past years. If in the past the consumer has been required to pay additional taxes at yearend, this will be evidence of an annual need for liquidity. If no taxes are withheld from some or all of the consumer's income streams, then the need for liquidity at tax time will be greater.

The nature of the income is also important as well as past history of the income stream versus inflation. If the income tends to fluctuate, this also needs to be known as well as a range of the expected fluctuation. If an income stream has a known ending point, that is also important. As an example, the consumer might have sold a piece of real estate and owner financed the sale but the payments will end in five years because the property will be paid off.

If the consumer is still working and producing income, the intended retirement date is important as well as any predicted changes in future earnings.

LIQUID NET WORTH

While some of the recommendations below are not specifically required by suitability laws, we submit them as additional measures to forecast future needs for liquidity and explore areas that may result in future needs for liquidity that may not be readily apparent to most consumers. Following these recommendations may ultimately result in a smaller annuity sale but should also result in a more thorough analysis of potential future needs for liquidity.

The consumer's liquid net worth should represent only the net value of assets after being converted to cash. Assets such as real estate (including the principal residence) should not be included in a liquid net worth calculation because of the speculative nature of the sale of real estate. Other assets, such as automobiles and household belongings, should not be included as liquid assets even if they could be sold with relative ease because they are utilized in the consumer's daily life and are not likely to be sold. If liquidation of an asset involves imposition of a surrender charge or other penalty, only the net value after imposition of the surrender charge or penalty should be considered.

LIQUIDITY NEEDS

If an asset is exposed to market risks, the future amount available for liquidity is difficult to gauge. Additionally, if the consumer is not yet 59½ years of age, the qualified retirement assets should not be counted as liquid due to the 10% early withdrawal penalty. Another consideration is the minimum distribution requirement. If the consumer is subject to this requirement, they should have sufficient retirement assets available for liquidation without penalty, surrender charge, or market risk to comply with the required distributions. Laddering of assets over time is a good strategy for providing future liquidity. It involves projecting liquidity needs into the future and determining which assets will provide that liquidity stream without penalty, surrender charge, or potential market loss.

AFFECT OF IRS EARLY WITHDRAWAL PENALTY ON LIQUIDITY NEEDS

If the one of the consumers is under 59½ their qualified retirement assets or any annuity should not be counted as liquid due to the 10% early withdrawal penalty imposed by the IRS on withdrawals from retirement plans or annuities prior to age 59½.

On the other side of this issue, if the consumer is already under the required minimum distribution requirement they should have sufficient retirement assets in a

position to be liquidated without penalty, surrender charge, or market risk to comply with the required distributions. Laddering of assets is a good strategy to provide future liquidity and involves projecting liquidity needs into the future and determining which assets will provide that liquidity stream without penalty, surrender charge or potential market loss.

TAX STATUS

The insurer and/or agent need to know the consumer's tax filing status (married, head of household, single, qualifying widow, etc.) as well as any taxes in arrears. If, because of how their income is paid to them, they end up having to pay taxes at the end of the year, this is important in that it affects liquidity needs.

CONSUMER FINANCIAL OBJECTIVES

The insurer or agent needs to get information from the consumer(s) about their investment objectives. Often the consumer needs to be asked numerous follow up questions for them to fully articulate their investment objectives. The timing and amount of future access to the intended funds should be determined to the best of the consumer's ability. This is a good time to question about the need for and existence of an emergency fund. It sometimes helps if the insurance agent repeats to the consumer what they think they heard as the stated investment objective—this gives the consumer an additional chance to sharpen their definition of their goals.

CONSUMER'S RISK TOLERANCE

Many insurers use some form of questionnaire designed to help determine risk tolerance. This completed questionnaire is often retained by the insurer to show that an attempt was made to determine risk tolerance. Generally speaking, the more financial risk the product would pose to the consumer, the more likely the insurer is to require a risk tolerance questionnaire. Many of these suitability questionnaires are structured so that they can be scored in the field by the agent and result in a numerical score that determines if the consumer's risk tolerance is within the range suitable for the product being recommended. When there is more than one person purchasing the annuity (such as husband and wife) the risk tolerance of both should be determined.

Consumers should ask themselves, ***"What types of risk am I willing to take with my money?"***

Market Risk – Products, such as stocks, that are directly tied to the performance of the economy have the potential for profit OR loss. Annuity owners have a guarantee of retaining the annuity principal; however, upside risk may be sacrificed.

Inflation Risk – Investing in a low risk product (such as a fixed annuity), leaves the possibility for the investment to underperform inflation, in which case the funds that went into the annuity may be worth less upon annuitization.

Taxation Risk – Annuities offer tax-deferred growth and only partial taxation upon annuitization. On the contrary, other products such as stocks have minimal tax benefits.

Liquidity Risk – Annuities do not have the same accessibility as other investments, such as stocks. All annuities contain surrender charges, so if liquidity becomes necessary, the minuses might outweigh the plusses.

INTENDED USE OF THE ANNUITY

The stated goal that the consumer hopes to accomplish by purchasing or exchanging the annuity should be determined. If the consumer states their goal as “to guarantee a stream of income that I can’t outlive,” then it appears that the annuity is designed to meet that goal. If, however, the consumer has nonqualified funds and states that their goal is “to invest this money and let it grow and pass to my children upon my death,” (which is classified as a wealth transfer goal) then the annuity might not be the best answer.

Since annuities are one of the few assets that do not “step up” in cost basis for federal income tax purposes, the consumer needs to be informed of this fact. While the annuity will grow tax deferred during the consumer’s life, upon their death all of the growth in the annuity (that was tax-deferred during accumulation) will be taxed as ordinary income when withdrawn.

SOURCE OF FUNDS USED TO PURCHASE THE ANNUITY

The insurer or insurance agent should determine the source of the funds used to purchase the annuity. If the source of funds would require liquidation and has unrealized capital gains that would be realized as part of the transaction, the agent should disclose to the consumer that it will be a taxable event when they liquidate the asset to provide the funds to purchase the annuity. Unless the insurance agent is also a CPA, they should not give specific tax advice to the consumer, nor should they attempt to estimate the amount of taxes that would be due. Many assets incur fees,

penalties, surrender charges and/or tax consequences when liquidated, surrendered, cancelled, or otherwise converted to cash. The consumer needs to understand these additional costs to the overall transaction.

ANTICIPATED RETIREMENT AGE

Retirement is not always a clear line in the sand. Often retirement is partial and involves re-hire-ment, where the retiree seeks some form of part-time employment to supplement their retirement. The retirement date desired by the consumer will obviously affect their retirement planning and liquidity needs. The anticipated retirement lifestyle and debt structure (if any) at the time of retirement will help determine the income needs at retirement.

CONSUMER'S FINANCIAL EXPERIENCE

The ability of the consumer to understand complex financial products will be affected by their level of financial experience. The producer needs to ascertain this level of experience and should never assume that the consumer understands a product.

FUTURE FINANCIAL CONSIDERATIONS

This category of information can involve many consumer goals. It could involve the future purchase of a recreation item (RV or boat), the purchase of real estate, the funding of education for loved ones, providing for potential long term care costs, cessation of employment, future cessation of a current stream of income, caring for a dependent (which could include a parent, child or grandchild), wealth transfer, or many other goals. The time horizon and amount needed to satisfy each of these future considerations will affect future needs for asset growth and liquidity.

SOCIAL SECURITY BENEFITS

The beginning date and amount of Social Security retirement benefits should be factored into the overall retirement plan of the consumer. This is facilitated by the fact that each Social Security taxpayer receives an annual report that estimates their retirement benefits. Of course, if they are already receiving Social Security retirement benefits, those amounts would have been captured under Annual Income earlier in the information gathering process.

Retirement Plan Distributions

If the consumer is anticipating any retirement plan distributions in the future, those amounts need to be estimated as to amount, start date and duration. If possible, these numbers should be expressed net of income tax.

Investing Retirement Assets

If the consumer has assets that are currently earmarked for retirement, the amount and current status of these funds needs to be determined.

Other Financial Needs

If the consumer has other financial needs that were not disclosed by them under the previous categories, now is the time for them to disclose them. There could be considerable overlap among several of these areas of financial considerations, but thorough questioning by the insurance agent can assure that the consumer has had ample opportunity to disclose all foreseeable financial needs, goals, and considerations.

Healthcare Concerns

With healthcare costs soaring, the ability to afford future medical care is a concern for many. Obviously the 65-year-old or older consumer can usually rely on Medicare Parts A & B to form the base of their primary healthcare delivery strategy. In addition, they will need to consider some form of supplement to the traditional Medicare as well as Medicare Part D to gain access to prescription drug coverage. In the case of a couple in which one of the consumers is not yet 65, the couple needs a strategy to afford health care for the younger spouse until he/she reaches Medicare eligibility. The potential cost of the need for custodial care should not be ignored and is often addressed through the purchase of a long-term care policy. Most states now have a long-term care partnership program, and the consumer should investigate the viability of insuring this risk. If a consumer needs long-term care services and does not have coverage, even the best-laid financial plans can be devastated.

Financial Support for Family Members

If the consumer is currently supporting or may in the future support family members (that weren't counted when determining dependents earlier), the cost of providing this support needs to be estimated. Often there is a degree of uncertainty as to whether

this support will be needed or not. A very common concern in this area is a child who is a single parent and struggling to make ends meet.

Cross-Selling Reverse Mortgages

One recent concern among state insurance regulators is the sale of annuities where the source of the funds is a reverse mortgage. There are currently laws in place at the federal level to prevent the same individual from selling both the reverse mortgage and an annuity to the same individual.

Other Information or Considerations

Any other information considered by the agent or insurer in making recommendations to consumers regarding the purchase or exchange of an annuity contract. If there is any other information that the insurance agent or insurer used in forming their reasonable basis for the recommendation, they need to document and quantify it to the highest degree possible.

Required Minimum Distributions

If the consumer holds or is purchasing a qualified annuity, care must be taken to make sure that sufficient liquidity (without surrender charges or market risks) to provide for the required minimum distributions.

Withdrawals in Excess of the Free Amount or Full Surrender

In the event of a withdrawal, access to annuity values in excess of the allowed penalty-free withdrawals should be considered as well as the likelihood of a full surrender. The consumer should understand the worst case scenario if they were to exceed the free withdrawal limit.

Available Annuitization Options

The consumer should understand the annuitization options available to them. It is best to have those numbers quantified and applied to their overall retirement plan to understand how the annuity fits within their goals, resources and objectives.

DISCLOSURE AS A COMPONENT OF SUITABILITY

Disclosure is an integral part of suitability in that the consumer must have access to certain facts and information in order to make an informed decision. When consumers are considering financing the purchase of another insurance contract using some or all of the values of an existing contract, they need to understand their rights and values in the insurance or annuity contract they already own.

To make a generalization, most financed purchases could accurately be called replacements. There are numerous strategies used by unscrupulous agents to circumvent replacement regulations, such as not listing the existing policies as a source of funds for the purchase of the new contract and then surrendering the existing contract after the new contract is issued. Another strategy is to borrow funds from or take a partial surrender of the existing contract to initially fund the new contract (at application), and then surrender or liquidate the remainder of the existing contract and funnel the proceeds into the newly established contract

The goal of various state regulations is to detect the most common strategies used to circumvent traditional replacement law, for the consumer to have sufficient information disclosed to them by the existing insurer and the new insurer.

APPROPRIATE SALES PRACTICES REQUIRE DISCLOSURE

Disclosing to the consumer that the purchase of an annuity is designed to address long-term needs and goals is essential to an appropriate and suitable sale. Failure of the producer to disclose these facts is both unethical and illegal. Failure on the part of the consumer to understand these facts may lead to undesirable taxable events and/or the loss of principal.

The following information concerning annuity contract benefits and features is typically contained in an annuity disclosure form and should be reviewed with the applicant alongside pertinent examples of each element in the contract:

- The guaranteed, nonguaranteed, and determinable elements of the contract—along with their limitations and how those limitations operate;
- The initial crediting interest rate of the annuity, including any bonus or introductory interest rates, the duration of such rates, and the fact that interest rates may change in the future and are not guaranteed;
- Guaranteed and nonguaranteed periodic option;

- Value reductions (surrender charges, contingent deferred sales charges) caused by withdrawals from, or surrender of, the annuity and the situations in which these value reductions will be assessed;
- How contract values may be assessed by the consumer, and any applicable reductions in annuity values and benefits resulting from access to contract values;
- Any available death benefits and the method of their calculation;
- A summary of the federal tax status pertinent to the contract, and any applicable tax penalties for withdrawal from the contract; and
- Impact, restrictions and cost of any rider.

In addition, the full disclosure and explanation to the consumer of the following elements of the proposed annuity will help them make an informed decision.

SURRENDER CHARGE TERMS

Terms of surrender charges — For each existing annuity the surrender charge needs to be explored. If it happens to be a two-tier annuity, additional understanding of the surrender charge is in order. If the annuity involves bonus amounts, the consumer's entitlement to those amounts needs to be determined and disclosed. Specifically the details of the surrender charge that should be determined and disclosed are as follows.

Dollar amount and surrender charge percentage — The percentage of the surrender charge, and to what values the percentage is applied, is important to understand and can be best determined by reading the contract. The actual resulting dollar amount of the surrender charge might need to be calculated if not shown.

Number of years in length — The length of the surrender charge (usually expressed in contract anniversaries or contract years) needs to be determined. Obviously, if the contract is old enough so that the surrender charge no longer applies, the consumer would need to understand this as well.

Note: If the existing annuity is a source of funds for the proposed annuity transaction and surrender charges will be assessed as part of the transaction, the consumer needs to understand the dollar amounts and percentages. These surrender charges represent part of the overall cost of the proposed transaction, and it can be misleading if these certain costs (in the form of a surrender charge) are offset against a bonus in the proposed annuity. Receipt of the bonus in the proposed annuity is contingent upon the consumer holding the proposed annuity for a certain period of

time; whereas, the surrender charges (if any) imposed by the existing annuity are certain to occur.

COMPARISON OF LIFE EXPECTANCY TO SURRENDER CHARGE PERIOD

Comparison of life expectancy of applicant — The length of the surrender charge (in both the existing and proposed annuity) as it relates to the remaining life expectancy of the owner is also very important. If the surrender charge exceeds the consumer's life expectancy then in essence they are making a lifetime commitment to this product, because in order to access funds (in excess of any free withdrawal allowed) at any time during their expected lifespan they will experience a surrender charge.

Waiver of surrender charge provision — Most annuities allow some waivers to their surrender charge. The various waivers and how they work were discussed earlier. The more waivers and the more generously worded they are, the less restrictive the surrender charge is viewed. However, if the consumer needs access to funds during the surrender charge period and their withdrawal does not fit into one of the waivers, they will experience shrinkage of annuity values due to surrender charges.

ANNUITY TAX STATUS AND POTENTIAL TAX PENALTIES

In the section on annuity taxation we covered many aspects of how the tax code impacts annuity owners. Where appropriate you should explain relevant tax aspects of the annuity to the consumer. If the consumer has tax questions specific to their tax situation, they should seek professional advice.

MORTALITY CHARGES AND EXPENSE FEES

If any charges and fees apply at any point during the term of the annuity contract, the producer should clearly disclose either specific dollar amounts or actual percentages and explain the circumstances under which these fees apply. A variable annuity disclosure (since the product is a securities product) is required to contain more details of fees and/or charges than fixed annuity or fixed indexed annuity disclosures. An example showing this difference involves premium taxes.

The variable annuity will disclose the premium taxes while the fixed annuity generally will not. The fixed annuity disclosure is not attempting to hide the premium tax—the tax is included in the cost structure of the fixed annuity and affects the guarantees of the product, and therefore it is not readily apparent. On the other hand, it would not

be a fair comparison to state that the variable annuity has a charge for premium taxes and the fixed annuity does not. While the charge for premium taxes is not disclosed separately in the fixed annuity, it is part of the product's overall costs. Producers should understand these differences and be able to explain them in a fair, understandable manner.

CURRENT VS. GUARANTEED INTEREST RATE

The consumer must understand the difference between the current and guaranteed interest rates and the fact that the current interest rate may change. In addition, the consumer should understand the mechanism that could cause a change in current interest, whether the mechanism is a decision by the insurance company, a movement in an index, or the change in the value of an underlying equity account.

INVESTMENT ADVISORY FEES

If any investment advisory fees are charged they will be disclosed in the prospectus, and the consumer should understand how they are charged.

CONTRACT RIDERS OR ENDORSEMENTS

There are many contract riders and endorsements that can be incorporated into annuities. The more common riders or endorsements are a death benefit (life insurance rider), some form of living benefit (discussed earlier), some form of living benefit based on loss of functional capacity/critical illness/dismemberment, or some form of living benefit based on terminal illness. They may also be in the form of a loan provision as part of an endorsement as a qualified retirement plan (403(b) or 401(k)). Many of the riders or endorsements are optional and are offered for a fee (usually expressed in basis points), while some are hard-coded in the product and built in to the guarantees offered by the product. The benefit and costs of each should be determined and disclosed to the consumer.

LIMITATIONS ON INTEREST RETURNS AND BENEFITS

As with most contracts, each annuity contract designs benefits for a particular set of circumstances. The contract contains limitations to clearly define the intent and parameters of each benefit and/or interest credit. Limitations commonly include a required holding period, a surrender charge, and upward limit on the benefit or interest credit. The consumer should understand these contract limitations.

Insurance and Investment Components

When the contract has separately identifiable insurance and investment components, they should be separately disclosed to the consumer.

Market Risk

If the consumer has a risk for loss of principal in an annuity, it should be disclosed.

If the Consumer Currently Holds an Annuity

If the consumer currently has an annuity (whether it is considered for exchange or not) the following information needs to be collected as part of the suitability determination process.

Surrender Charges Existing and New Annuity

If the consumer will experience a surrender charge as they exit the annuity that is being used as a source of funds for the transaction, the amount of the surrender charge should be disclosed to the consumer. The consumer should consult with their current insurer to see if changes are available within the existing annuity that meet the requirements they seek in a new annuity.

The annuity that is being purchased as part of the replacement transaction will most likely have surrender charges and the consumer needs to understand how these work.

Costs for Annuity Benefits

All benefits of each annuity, including riders, options, and endorsements, should be disclosed and compared. Rarely will any two annuities be identical in benefits, so the comparison will not always be symmetrical and will demonstrate benefits in one contract that do not exist in the other and vice versa.

With many of the benefits offered by annuities, it is difficult to quantify (in dollar terms) the value of each benefit, and often the consumer has to make a value judgment based on their understanding of the benefit as it applies to them. As an insurance agent you can assist the consumer by disclosing all relevant information in a fair and straightforward manner.

Will the Consumer Benefit from Enhancements in the New Policy

Part of determining suitability is to determine if the product being sold to replace an existing product has a benefit or enhancement that the consumer does not possess in their current product.

Whether or not the enhancement is of value to the consumer is a decision they can only make when they understand the full cost (monetary and otherwise) of the replacement transaction. If the consumers believe that the new product will allow them benefits they don't currently have and they feel that these benefits are worth the cost of the transaction, then they have made a value decision.

Annuity Replacements Within 36 Months

If the consumer has had an annuity replacement within the previous three years, the potential is high that they will bail out of the product being sold to them today while a surrender charge is still effective.

Since 2008 part of the regulations for the suitability of deferred variable annuities has required additional scrutiny of any annuity replacement where the consumer has had an annuity replacement within the previous 36 months (three years).

Annuity Classification Based on Policyowner Risk

Because fixed annuities guarantee fixed, monthly payments, those payments will vary and will depend upon the performance of the investment options chosen by the insurer. A variable annuity offers a wider range of investment options than a fixed annuity, and the contract owner chooses those investment options. In a variable annuity the value of the investments chosen by the contract owner varies in accordance with the total investment performance of the contract. The fluctuation of the cash value and monthly income is the main difference between variable and fixed annuities. Typically, variable annuities allow equity investments and fixed investments, whereas a fixed annuity offers only fixed investments.

Filling the Consumer's Need with a Variable Annuity

Following is a list of questions the consumer should ask and the producer should be ready to answer.

- How long will my money be tied up? Are there surrender charges or other penalties if I withdraw funds from the investment earlier than I anticipated?

- Will you be paid a commission or receive any type of compensation for selling the variable annuity? How much?
- What are the risks that my investment could decrease in value?
- What are all the fees and expenses?

Other questions the consumer should ask themselves:

- Am I already contributing the maximum amount to my 401(k) plan or other tax-deferred retirement plans?
- Do I have a long-term investment objective? Am I going to need the money before the surrender period ends? Will I need the money before I'm 59½?
- Do I understand how the variable annuity works, the benefits it provides, and charges I have to pay?
- Have I read and understood the prospectus?
- Are there special features provided such as added long-term care insurance that I don't need?
- If I've decided to purchase a variable annuity, have I shopped around and compared the features of various variable annuities, such as sales loads and other fees and expenses?
- Do I understand the effect annuity payments could have on my tax status?
- If I'm considering purchasing a variable annuity within an IRA, do I understand that IRAs already provide for tax-deferred savings?
- Am I being pressured into making a quick purchase?

KEY POINTS TO PONDER

- Producers are required to document in writing a “reasonable basis” for making an annuity recommendation to a consumer.
- Producers are required to obtain personal information on all parties to the annuity.
- Producers are required to obtain information regarding the consumer’s current financial situation, such as current assets, income tax circumstances, liquidity needs, and resources.
- The consumer’s current financial situation includes information related to their current assets, income tax circumstances, liquidity needs, and resources; assets such as real estate is not included in a liquidity net worth calculation because of the speculative nature of the sale of real estate; if a consumer is under 59½ their qualified retirement assets or any annuity should not be counted as liquid due to the possibility of the early withdrawal penalty.
- Annuities do not “step up” in cost basis.

CHAPTER 12 REVIEW QUESTIONS

Which of the following answers/completes each question/sentence the best?

(Answers are in the back of the text.)

1. Before an annuity transaction is recommended, the agent/insurer must document in writing a _____ for making the recommendation.

   a) reasonable basis
   b) commission schedule
   c) reason
   d) purpose

2. "_____" is taking a situation where an annuity makes sense for the consumer but the agent recommends that too much of their assets be put into an annuity.

   a) Underselling
   b) Overselling
   c) Overrating
   d) Exaggerating

3. The producer must obtain personal information on _____ during the annuity sales phase.

   a) all parties to the annuity
   b) the contract owner
   c) the contract annuitant
   d) the contract beneficiary

ANSWERS TO CHAPTER REVIEW QUESTIONS

Following are the correct answers to the chapter review questions—listed by chapter, question number, the correct answer, and the section where the answers can be found within the course material.

CHAPTER 1

Question #	Correct Answer	Reference
1	a	So Just What is an Annuity?
2	d	So Just What is an Annuity?
3	a	So Just What is an Annuity?

CHAPTER 2

Question #	Correct Answer	Reference
1	a	Qualified or Nonqualified – What's the Difference?
2	b	Qualified or Nonqualified – What's the Difference?
3	a	Annuity Guarantees

CHAPTER 3

Question #	Correct Answer	Reference
1	a	Variable vs. Fixed Insurance Products
2	a	The Fixed Annuity
3	b	Advantages of Variable Annuities

CHAPTER 4

Question #	Correct Answer	Reference
1	a	Immediate or Deferred – Which One?
2	b	Advantages of Immediate Annuities
3	a	Immediate Variable Annuity

CHAPTER 5

Question #	Correct Answer	Reference
1	d	Popularity of Indexed Products
2	b	Popularity of Indexed Products
3	c	Surrenders During the Term

CHAPTER 6

Question #	Correct Answer	Reference
1	d	The Hybrid Annuity
2	a	The Hybrid Annuity
3	A	CD-Type Annuities

CHAPTER 7

Question #	Correct Answer	Reference
1	c	Long-Term Care Benefit Rider
2	a	Long-Term Care Benefit Rider
3	b	Waiver of Surrender Charge vs. LTC Rider

CHAPTER 8

Question #	Correct Answer	Reference
1	a	Living and Death Benefit Riders
2	b	Living and Death Benefit Riders
3	c	the Guaranteed Minimum Death Benefit Rider

CHAPTER 9

Question #	Correct Answer	Reference
1	d	Indicators of Diminished Mental Capacity
2	b	Unique Ethical and Compliance Issues Dealing with Seniors
3	b	Senior-Related Professional Designations

CHAPTER 10

Question #	Correct Answer	Reference
1	a	Exclusion Ratio
2	c	Exclusion Ratio
3	b	Exclusion Ratio

CHAPTER 11

Question #	Correct Answer	Reference
1	a	Annuity Suitability and Best Interest Standard
2	c	Annuity Suitability and Best Interest Standard
3	d	FINRA Rule 2330 Supersedes NASD Rule 2821

CHAPTER 12

Question #	Correct Answer	Reference
1	a	Determining Consumer Suitability
2	b	Overselling
3	a	Personal Information