

Annuity Basics

Learning Objectives

- Define an annuity and distinguish between individual and group annuities.
- List the key players involved in an annuity contract and describe their roles.
- Describe two key attributes of an annuity.
- Define a single-premium immediate annuity (SPIA) and explain how it works.
- Identify and distinguish among the types of payout options available under annuity contracts.
- Define a deferred annuity and distinguish it from an immediate annuity.
- Describe the ways that contract owners can access the funds in their deferred annuities, and explain why few owners annuitize their contracts.

Introduction to Annuities

Learning Objectives: Define an annuity and distinguish between individual and group annuities. List the key players involved in an annuity contract and describe their roles. Describe two key attributes of an annuity.

- Annuities are a financial product that allows for the accumulation, protection, and distribution of assets.

An [annuity](#) is a financial product that offers individuals a way to accumulate and protect assets, with the option of converting those accumulated assets into a sustainable stream of income. An annuity guarantees a stream of income through a series of periodic payments known as [annuity payments](#) in exchange for one or more premiums. In this course, we will use the terms *annuity contract* and *annuity* interchangeably.

Individual and Group Annuities

An annuity that a person buys is an [individual annuity](#), as opposed to a *group annuity*. Recall from Module 1 that a plan sponsor purchases a *group annuity* to provide annuity payments at retirement to plan participants. We'll discuss only individual annuities in this module.

The parties to an annuity contract are the [insurance company](#) and the [contract owner](#). A contract owner that is not a real person is often called a [non-natural owner](#).

In the United States, only insurers can **issue** an annuity—which means assuming the risk associated with the annuity. However, insurers, banks, broker-dealers, and investment companies can all **sell** annuities. Although banks, broker-dealers, and investment companies can sell and distribute annuities, they **are not** parties to the contract.

Annuities come in many different varieties. Even the same type of annuity may differ from company to company, so understanding the terms of the annuity contract is very important.

Annuity: A legally enforceable written agreement between an insurance company and a contract owner under which the contract owner makes a single premium payment or a series of premium payments to the insurance company. In exchange, the insurer promises to make a series of payments to a named person or entity. Annuities can also be used to accumulate assets, with the option of creating a series of payments later.

Annuity payments: The monthly, quarterly, semiannual, or yearly periodic income payments that the insurer promises to pay under the terms of an annuity.

Individual annuity: An annuity purchased and owned directly by a person or purchased by a legal entity, such as a trust, on behalf of a person.

Insurance company: A financial institution that provides protection against the risk of financial loss caused by specified events. Also known as an insurer.

Contract owner: The person or other entity who owns and exercises all the rights and privileges of an annuity contract.

Non-natural owner: For nonqualified annuities, an entity, such as a trust, partnership, or corporation, that owns the annuity contract.

Key Players

Who's the annuitant?

The [annuitant](#) is the person whose lifetime the insurance company uses to determine the amount and duration of annuity payments payable under an annuity contract. Typically, annuity contracts state that the insurer will make annuity payments to the annuitant.

What does the term payee mean?

The [payee](#) is a natural person or legal entity designated by a contract owner to receive annuity payments if the annuitant does not receive them.

What's a beneficiary?

The [beneficiary](#) is the person or legal entity who may receive the remaining value of the annuity contract upon the death of the contract owner or annuitant.

Who's a joint annuitant?

A [joint annuitant](#) is a person, in addition to the primary annuitant, whose lifetime the insurance company uses to determine the amount and duration of annuity payments payable under an annuity contract.

Note that annuitants and joint annuitants must be people—but payees and beneficiaries can be either people or legal entities, such as trusts or corporations.

For many annuity contracts, **Contract Owner = Annuitant = Payee**

Two Key Attributes of an Annuity

Annuities have two attributes that make them an attractive way to save for retirement:

They guarantee a lifetime stream of income.

Although some bank accounts are insured by the Federal Deposit Insurance Corporation (FDIC), only annuity contracts can guarantee annuity payments. The issuing insurance company guarantees these payments. In the unlikely event that the insurer becomes insolvent, the state [guaranty associations](#) offer some relief to consumers.

Their favorable tax treatment promotes long-term savings.

To encourage people to save for retirement, the Internal Revenue Code (IRC) grants favorable tax treatment to people who purchase annuities. Taxes are not usually required on annuity earnings until they are withdrawn from the annuity. Note that some annuities lose the advantage of tax-deferred earnings if they are owned by certain non-natural persons, such as trusts or corporations.

- In the United States, only insurers can *issue*—that is, assume the risk associated with—an annuity. Insurers, banks, broker-dealers, and investment companies can all *sell* annuities.

Que. Robert Connelly purchased an annuity from Silver Star Bank. Onyx Life Insurance Company will issue the annuity. Robert wants to start receiving annuity payments when he retires. Robert and his wife, Madge, will receive payments until the last one dies. Their daughter, Karen, will receive any value that remains in the annuity contract after both Robert and Madge die.

The parties to this annuity contract are

Ans: The parties to an annuity contract are the insurance company (Onyx Life) and the contract owner (Robert). Silver Star Bank sells the annuity but is not a party to the contract.

Madge is a joint annuitant because the insurer uses her lifetime, in addition to Robert's lifetime, to determine the amount and duration of annuity payments. Karen is the beneficiary because she will receive the remaining value of the annuity contract after Robert and Madge die.

Immediate Annuities and Payout Options

Learning Objectives: Define a single-premium immediate annuity (SPIA) and explain how it works. Identify and distinguish among the types of payout options available under annuity contracts.

Which statement do you think best describes the type of annuity known as an *immediate annuity*?

- ☐ An immediate annuity is most appropriate for older individuals who want to defer income payments until late in life.
- ☐ An immediate annuity is most appropriate for younger individuals who have very little in savings and must pay for the annuity over time.
- ☒ An immediate annuity is most appropriate for individuals who want to receive annuity payments not more than one year after the purchase date.

That's correct!

People about to retire may consider purchasing an immediate annuity to use as a source of retirement income. Let's learn more about them.

Immediate Annuities

An [immediate annuity](#) begins making annuity payments within one year after purchase. These annuities are also known as [single-premium immediate annuities \(SPIAs\)](#) because they require only one lump-sum premium payment.

SPIAs allow contract owners to

- Use a lump sum from another source, such as a retirement plan account balance, as the premium payment. This feature makes SPIAs a popular retirement product, especially for individuals who aren't covered by a pension plan.
- Begin receiving annuity payments immediately, but not more than one year later.

Immediate annuity: An annuity under which the annuity payments begin no later than one year after the annuity is purchased.

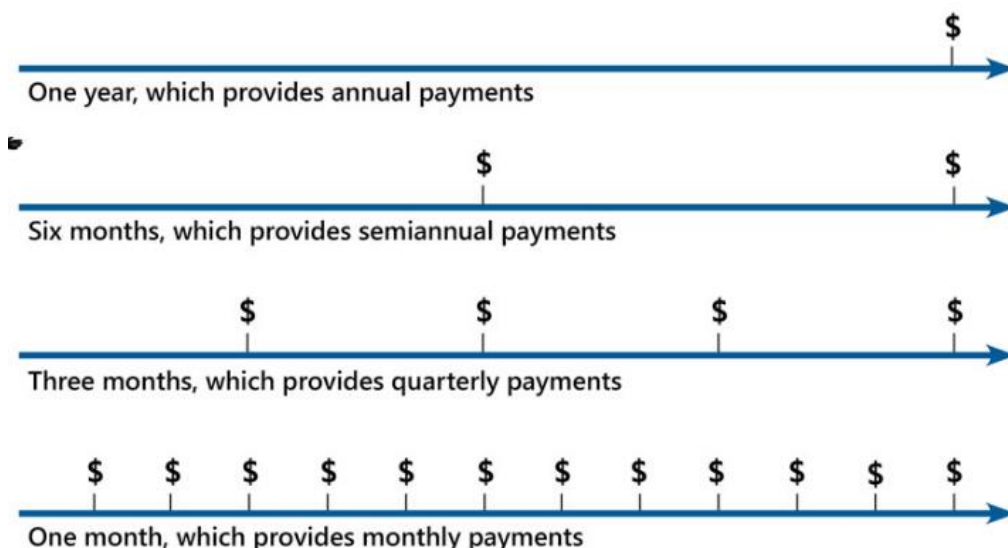
Single-premium immediate annuity (SPIA): An annuity in which the contract owner makes one lump-sum premium payment and begins receiving annuity payments immediately or no more than one year after the annuity is purchased.

Annuity period: The time span between each annuity payment.

Payout factor: The amount of each monthly annuity payment per thousand dollars of premium (for an immediate annuity) or accumulated value (for a deferred annuity).

Annuity Periods

How often the insurer makes annuity payments depends on the [annuity period](#) selected by the contract owner. Annuity periods can be



Annuity periods of one month and one year are the most common.

So how does the insurer come up with the amount of that annuity payment?

The answer has to do with something called a [payout factor](#).

For a SPIA, the basic formula for determining the actual amount of each annuity payment is

$$\text{Immediate annuity payment} = (\text{Single premium} \div 1,000) \times \text{Payout factor}$$

Let's see how an example of this works

Example: Faye Dodge is about to retire at age 65 with a 401(k) account balance of \$1,500,000. Faye wants to use \$500,000 of this account balance to purchase a SPIA that will begin making monthly payments to her in one month. These payments will continue for the rest of her life. For a female age 65, the insurance company assesses a monthly payout factor of 6.27 per \$1,000 of premium.

Analysis: Under this SPIA, the insurance company will pay Faye \$3,135 per month for the rest of her life, found as $(\$500,000 \div \$1,000) \times 6.27$.

Factors Affecting Annuity Payments

Below, learn about factors at the time of purchase that affect lifetime annuity payments for a SPIA.

What affects SPIA payments?

Amount of the Premium: The larger the premium payment, the larger the lifetime annuity payment.

Age of the Annuitant: An older annuitant will likely receive higher payments than a younger annuitant who pays the same premium because the older annuitant has a shorter life expectancy. Thus, the insurer expects to make fewer payments.

Sex of the Annuitant: Statistically, females live longer than males, so a female's payments are likely to be lower than those for a male of the same age.

The true rate of return on a SPIA that provides annuity payments for life is unknown at the time of issue because the length of the annuitant's life is unknown, but it can be determined at the annuitant's death.

Payout Options Based on Life Expectancy

Insurers offer different [payout options](#), (The choices a contract owner has as to how the insurer will distribute the annuity payments. Also known as annuity options.) which let contract owners choose how they will receive annuity payments.

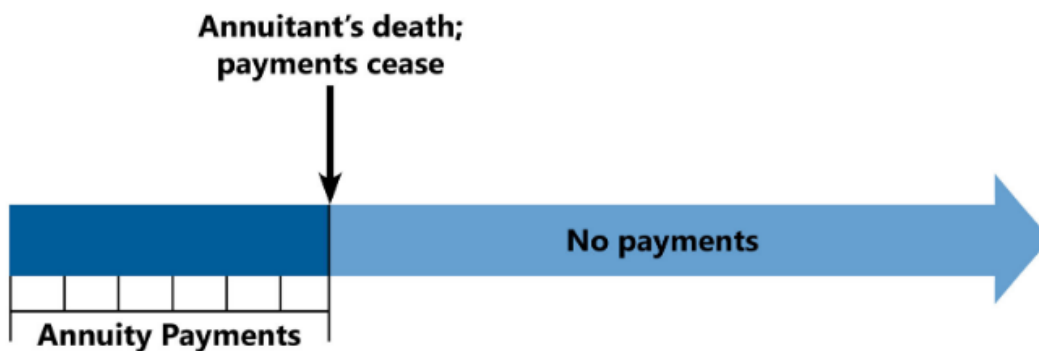
Payout options affect

- The amount of each annuity payment
- How long annuity payments continue
- Taxes

As a result, choosing the correct payout option is an important decision.

Life Annuity

The [life annuity](#) (also known as the *life only annuity* or *straight life annuity*) makes payments for the lifetime of the annuitant. When the annuitant dies, the payments end. The SPIA that Faye purchased is an example of a life annuity.



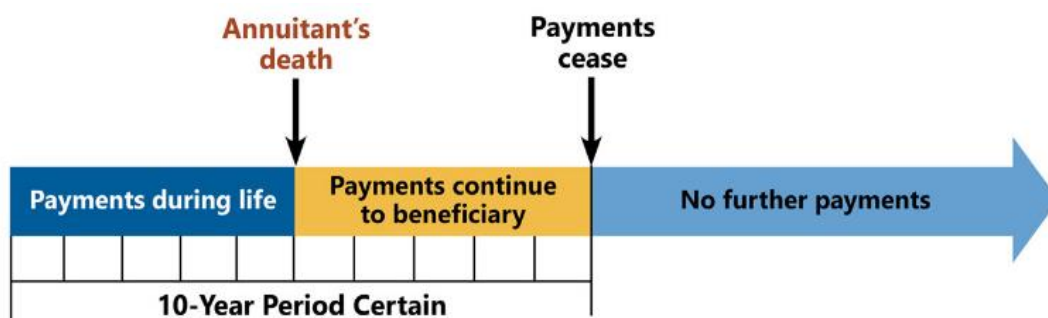
As the contract owner, Faye may receive more in payments than she paid into the annuity if she lives longer than the insurer expected when it issued her contract. However, she'll receive less than she paid if she dies sooner than expected.

Despite the potential advantage of receiving more in payments than they paid for the annuity, few contract owners are willing to accept the possibility that they will die too soon and not get their money back. According to LIMRA, only about 12% of contract owners select the life annuity option. Most buyers of SPIAs choose payout options containing some kind of guarantee—whether it's a guarantee of receiving payments for at least a specified time or a guarantee of return of principal.

Life Income with Period Certain

A [life income with period certain annuity](#) guarantees that the insurer will make payments for the annuitant's lifetime and for at least a specified period of time, even if the annuitant dies before the end of that time period. The guaranteed period is known as the *period certain*.

The contract owner specifies the length of the period certain—which is usually 5, 10, 15, or 20 years—when the contract is purchased. The owner also designates a beneficiary to receive annuity payments if the annuitant dies before the end of the period certain.



Life Annuity: A payout option that guarantees the insurer will provide annuity payments for only as long as the annuitant lives.

Life Income with Period Certain annuity: A payout option that guarantees the insurer will provide annuity payments throughout the annuitant's lifetime and guarantees that the payments will be made for at least a specified period, even if the annuitant dies before the end of that period.

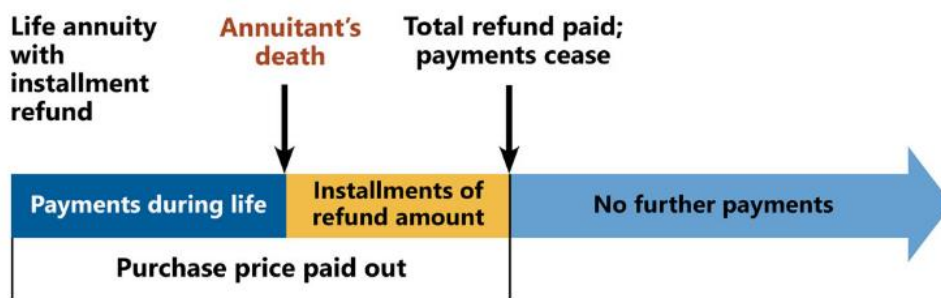
Life income with refund annuity: A payout option that guarantees the insurer will provide annuity payments throughout the annuitant's lifetime and guarantees the insurer will pay benefits at least equal to the annuity's purchase price if the annuitant dies. Also called a refund annuity.

Joint and survivor annuity: A payout option that provides a series of annuity payments based on the life expectancies of two annuitants, and those payments continue until the last annuitant dies.

Life Income with Refund Annuity

A [life income with refund annuity](#) makes payments throughout the lifetime of the annuitant and guarantees that at least the purchase price of the annuity will be paid out.

If the annuitant dies before the total purchase price of the annuity has been paid out, the insurer will pay the beneficiary the difference between the annuity payments made and the purchase price of the contract. Some annuity contracts give the contract owner a choice of a lump-sum refund or an installment payment refund.



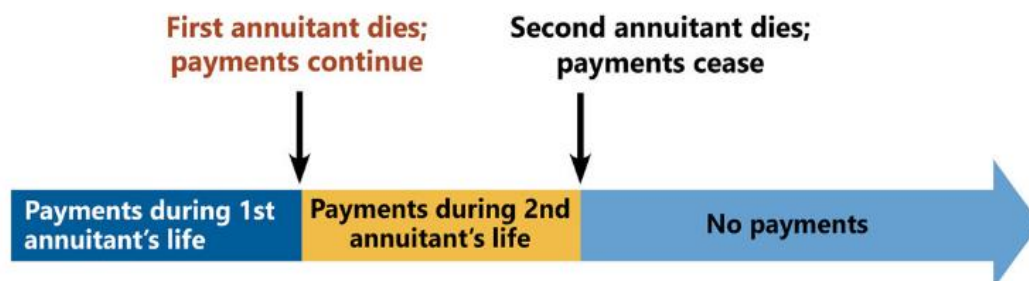
Joint and Survivor Annuity

A [joint and survivor annuity](#) makes payments based on the life expectancies of two annuitants, and payments continue until the *last* annuitant dies.

The annuity contract specifies whether payment amounts

- Remain the same after the first annuitant dies, or
- Decrease by a stated amount, such as 50%, should one annuitant survive the other

All life contingent options—life annuity, life income with period certain annuity, and life income with refund annuity—can be based on a single life or joint lives. The following illustration is of a joint and survivor life annuity.



Payout Options Not Based on Life Expectancy

Some people want annuities that guarantee payments for a certain period of time or for a specific amount, without being based on the annuitant's life expectancy.

Let's see what kinds of options they have.

Fixed Period Annuity

The [fixed period annuity](#) guarantees annuity payments for a specified time period. If the annuitant dies, the insurer pays the remaining annuity payments to a beneficiary until the end of the specified period.

Example: Joe Bingham purchased a 20-year fixed period annuity. He named his wife, Trish, as the beneficiary.

Analysis: Joe's annuity will pay \$540 per month for 20 years. If Joe lives for 27 years after his payments begin, he will receive payments for only 20 of those years. If, however, Joe dies 8 years after payments begin, the insurer will continue to make payments to Trish for 12 years.

A fixed period annuity can create a temporary income stream to delay taking Social Security benefits or to supplement other income sources for a specified period of time.

Fixed Amount Annuity

As its name suggests, a [fixed amount annuity](#) (A payout option that guarantees the insurer will provide annuity payments of at least a specified minimum amount for as long as the premium payment will provide, regardless of whether the annuitant is living.) provides annuity payments of a specified amount. With a fixed amount annuity, the contract owner informs the insurer of the premium she will pay and the amount of each annuity payment. The insurer then calculates how long the premium plus interest can provide annuity payments of the specified amount.

If the annuitant dies before the annuity payments equal the premium paid, the insurer will pay the remaining annuity payments to the beneficiary.

Example: Max Crider bought a fixed amount annuity paying \$1,000 each month and designated his son, Michael, as his beneficiary. His premium is \$250,000.

Analysis: The insurer will inform Max of how long he will receive monthly annuity payments of \$1,000, as well as the amount of the last payment, which will be less than \$1,000. If Max dies before the annuity payments have equaled the premium paid, Michael will receive the remaining annuity payments.

Payment Considerations

The longer the insurer is likely to make annuity payments—as a result of a guaranteed period certain, a refund, or joint life expectancies—the lower the annuity payments will be.

Insurers frequently offer a cost of living adjustment (COLA) option with SPIAs. A COLA helps the amount of the annuity payments keep up with inflation. Typically, a COLA option increases the annuity payments by a set percentage each year.

Some COLAs tie the annuity payments to the Consumer Price Index. In that situation, annuity payments may increase each year, but they are lower to begin with than they would have been without the COLA.

Commutation Rights in SPIAs

Some, though not all, SPIAs allow the contract owner to exercise what's known as a [commutation right](#), where the owner receives a lump-sum payment from the contract's principal—even while the owner is receiving annuity payments under the contract. Under a typical commutation right, the owner is permitted to "commute" a portion of the future payments, such as 40%. If the owner chooses commutation, the remaining annuity payments will be lower.

Commutation right: A right sometimes included in an annuity contract that allows a lump-sum payment from the contract's principal even while the contract owner is receiving annuity payments.

The following situations describe different payout options for annuities. Select the answer choice that illustrates the payout option known as a life income with period certain annuity.

- ☐ Drew and Beth Dawson own an annuity under which payments will continue until both of them have died.
- ☐ Mable Cowan owns an annuity that makes payments for as long as she lives. When she dies, the payments end.

Mable Cowan's annuity has a payout option known as a **life annuity**.

- ☒ Kyle Bastrop's annuity will make annuity payments for at least 10 years. If he dies before the end of that period, the insurer will continue payments to his beneficiary. If he lives beyond 10 years, the insurer will make payments until he dies.

With the payout option known as a life income with period certain annuity, the annuitant knows that payments will be made for at least the specified period (in this case, 10 years); if he lives beyond that period, he will continue to receive payments until his death.

Deferred Annuities

Learning Objectives: Define a deferred annuity and distinguish it from an immediate annuity.

Describe the ways that contract owners can access the funds in their deferred annuities, and explain why few owners annuitize their contracts.

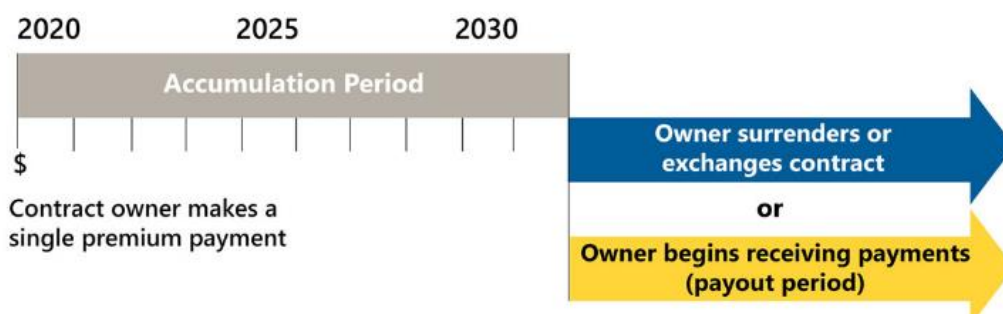
Remember Faye Dodge? Her best friend, Angela Townsend, is also interested in purchasing an annuity. Her situation is slightly different, though. Angela is 58 years old and plans to retire in ten years. Her aunt recently died and left her an inheritance. Angela would like to use this money to purchase an annuity; however, she is still working full time, so she doesn't currently need an income stream.

- For Angela's situation, a single-premium deferred annuity would probably make the most sense. Let's learn more about deferred annuities.

Introduction to Deferred Annuities

Some people want to accumulate savings and allow those savings to increase in value over time. For these people, a [deferred annuity](#) may be a good option. A deferred annuity has an [accumulation period](#), which extends from the time the contract owner purchases the contract until the owner either begins receiving annuity payments, surrenders the contract, or exchanges the contract.

A deferred annuity can be classified as a [single-premium deferred annuity \(SPDA\)](#) or a [flexible-premium deferred annuity \(FPDA\)](#). However, most deferred annuities are SPDAs. The figure below illustrates a typical SPDA.



Deferred annuity: An annuity contract under which payment of the annuity payments is deferred for a period of time. The deferred annuity gets its name from the deferral of annuity payments and not from the deferral of taxes.

Accumulation period: The period between the contract owner's purchase of a deferred annuity and either the date when the contract's payout period begins, the date when the contract's surrender value is paid, or the date when the contract is exchanged.

Single-premium deferred annuity (SPDA): An annuity that allows for a single lump-sum premium payment and under which annuity payments are deferred for a period of time, usually more than a year, after the contract is purchased.

Flexible-premium deferred annuity (FPDA): An annuity that allows the contract owner to make multiple premium payments after the contract is issued and under which annuity payments are deferred for a period of time, usually more than a year, after the contract is purchased. Often abbreviated as FPDA.

Accumulated value: During a deferred annuity's accumulation period, the amount paid for the deferred annuity, plus earnings, minus the amount of any withdrawals and fees. Also known as accumulation value, contract value, or account value.

The contract owner's premiums generate earnings during the accumulation period. The total of the premiums and earnings, less any withdrawals and charges assessed by the insurer, is called the [accumulated value](#).

Accumulated Value = Premiums + Earnings – (Withdrawals + Charges)

The contract owner can withdraw some or all of his money during the accumulation period.

Accessing Funds in a Deferred Annuity

If a contract owner wants to access funds from the annuity's accumulated value, the following options are usually available:

- Taking withdrawals
- Surrendering the contract
- Annuitizing the contract

These choices are not mutually exclusive. Let's look at each option.

Que. Chang Lee's deferred annuity allows for withdrawals of 10% of the accumulated value each year. What do you think the insurer will do if Chang requests a withdrawal of 15% in the second year of the contract?

Ans: The insurer can't cancel the contract or limit the amount of Chang's withdrawal. However, if Chang's contract limits the amount of penalty-free annual withdrawals to a certain percentage, the insurer is likely to assess a penalty charge on any amount taken in excess of that percentage.

Withdrawals and Surrenders

Deferred annuities typically allow the contract owner to take [withdrawals](#) from the accumulated value during the accumulation period. A typical contract allows the owner to withdraw 10% of the accumulated value each year. Withdrawals, however, reduce the annuity's accumulated value and may result in a surrender charge from the insurer, as well as federal taxes. [Surrender charges](#) help insurance companies recoup the acquisition costs incurred in issuing and selling contracts.

An insurer imposes a surrender charge when the contract owner either (1) takes withdrawals in excess of those allowed by the contract or (2) fully surrenders the contract before the expiration of the surrender charge period. A full surrender terminates the contract, and the contract owner receives the contract's [surrender value](#).

Surrender charges typically apply during the early years of the contract and decrease each year until the end of the surrender charge period. The reason for this decrease—and the eventual elimination of the charge—is that, the longer the contract is in force, the more of the acquisition costs the insurer is able to recover through invested premiums and/or charges on the products.

Withdrawal: A transaction in which the owner of a deferred annuity contract elects to receive a portion of the contract's accumulated value during the accumulation period. Also known as a partial surrender or partial withdrawal.

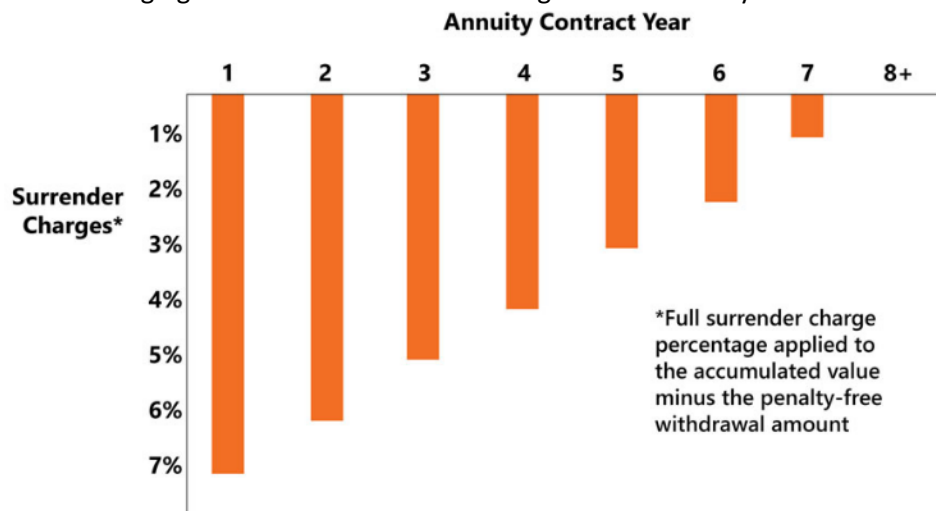
Surrender charge: A fee an insurer imposes when a deferred annuity contract owner makes excess withdrawals as defined in the contract or fully surrenders the contract before the surrender charge period is over. Also known as a contingent deferred sales charge.

Surrender value: The amount of a deferred annuity's accumulated value, less any surrender charges, that the contract owner is entitled to receive if the contract is surrendered during its accumulation period.

Annuitization: The optional process of converting the accumulated value of a deferred annuity into annuity payments.

Payout period: The period during which the insurer makes guaranteed annuity payments.

The following figure illustrates surrender charges for an annuity.



*Note: With a flexible-premium annuity, each deposit typically has its own surrender schedule.

Annuitization

Annuitization is the optional process of converting the accumulated value of a deferred annuity into annuity payments; if the contract owner chooses to annuitize, the contract enters the **payout period**. In this case, the owner must select a payout option that determines how the insurer will distribute the payments.

Upon annuitization,

- The deferred annuity basically becomes an immediate annuity.
- The insurer begins making annuity payments on the **annuity start date**.

Most contract owners do not annuitize their contracts. They usually choose to take systematic withdrawals from the accumulated value instead.

Why is that?

The answer has to do with balancing two major risks that individuals face—longevity risk and liquidity risk. *Longevity risk* is the risk of outliving your assets. Annuitizing can protect against this risk if the individual chooses to receive guaranteed income for life. By annuitizing, though, the individual may lose control over the funds in the annuity. That's *liquidity risk*—the risk of not being able to access your funds in the event of an emergency. Some annuity contracts contain a *commutation right*, described earlier, which allows the contract owner to receive a lump-sum payment from the contract's principal. Another option is to take systematic withdrawals; in this case, the contract owner can access the funds in the annuity without annuitizing.

The following chart summarizes the differences between immediate and deferred annuities.

	Immediate Annuity	Deferred Annuity
Purchased with a single premium or multiple premiums?	Always a single premium	Either, but single premium is the most common
Payout period?	Yes	No, unless annuity is annuitized
Accumulation period?	No	Yes
Owner loses ownership and control of the funds?	Yes, unless the contract contains a commutation right	No
Can owner withdraw funds from the annuity?	No, unless the contract contains a commutation right	Yes, although withdrawing funds during the accumulation period may result in charges or taxes

Que. Mindy Duggan purchased a deferred annuity from Good Day Life Insurance Company. Eight years later, Mindy is considering surrendering her deferred annuity. Will Mindy receive annuity payments if she surrenders her annuity?

Ans: If Mindy surrenders her annuity, she will receive the annuity's accumulated value minus any surrender charges imposed by the insurer.

- Annuity contracts typically contain higher surrender charges during the early years of a contract, and these charges usually decrease each year until the end of the surrender charge period.

Learning Objectives:

- Describe the guarantees included in traditional fixed annuity contracts, such as fixed-rate deferred annuities (FRDAs).
- Explain how fixed indexed annuities (FIAs) differ from traditional FRDAs.
- Explain how a fixed deferred annuity with a market value adjustment (MVA) works.
- Explain how deferred income annuities (DIAs) and qualified longevity annuity contracts (QLACs) differ from FRDAs and immediate annuities.
- Describe the features that distinguish variable annuities from traditional FRDAs, and explain how insurers determine the accumulated value of a variable annuity.
- Describe the death benefit and living benefit riders that variable annuities offer.
- Describe the charges insurers impose on variable annuities.
- Compare and contrast a registered index-linked annuity (RILA) with a traditional variable annuity and a fixed indexed annuity (FIA).
- Apply the risk-return trade-off to the different types of deferred annuities.

Fixed Annuity Guarantees

Que: Annuities can be classified as fixed or variable annuities. Who do you think bears the investment risk for a fixed annuity?

Ans: For fixed annuities, insurers—not contract owners—bear the investment risk, making these products an attractive option for risk-averse individuals. Let’s learn more about fixed annuities.

Fixed Annuities

An insurer bears the investment risk for all its [fixed annuities](#)—whether they are immediate or deferred—so the insurer deposits the premiums for these annuities in its [general account](#).

We discussed single premium immediate annuities (SPIAs) in "Annuity Basics: Part 1." Although variable SPIAs exist, they are relatively rare. So, SPIAs are usually fixed annuities. Now let’s look at a more popular product—fixed *deferred* annuities—starting with fixed-rate deferred annuities, or FRDAs.

Fixed-Rate Deferred Annuities

[Fixed-rate deferred annuities](#), or FRDAs, combine the principal and interest-rate guarantees of a fixed annuity with the asset accumulation properties of a deferred annuity. Clients often purchase FRDAs to protect and grow their principal and avoid market risks.

With an FRDA, the interest-rate guarantee ensures that the accumulated value will increase over time and the contract owner will never lose any of the premiums—or principal—paid into the annuity (unless possibly when the contract owner surrenders the contract during the surrender charge period).

Fixed annuity: An annuity contract under which the insurer guarantees (1) a minimum interest rate that will be applied to the accumulated value (for fixed deferred annuities) and (2) the minimum amount of the annuity payments that will be paid (for fixed immediate annuities).

General account: An asset account that an insurer uses to support all of the company's general obligations, including contractual obligations to owners of guaranteed insurance products, such as fixed annuities.

Fixed-rate deferred annuity: A type of annuity contract in which the insurer guarantees a minimum interest rate that will be applied to the accumulated value. Often abbreviated as FRDA.

During the accumulation period, the accumulated value of an FRDA earns interest in one of two ways:

- **Guaranteed minimum interest-crediting rate-**
The insurer states a guaranteed minimum interest-crediting rate in the contract. For example, an insurer might guarantee a minimum interest-crediting rate of 0.50%. In this case, the contract’s accumulated value will never earn less than 0.50%.
- **Current interest-crediting rate**
An insurer declares and pays this rate on the contract’s accumulated value for a specified period. Insurers

typically offer different current interest-crediting rates, depending on the term chosen by the contract owner—for example, a three-year, four-year, or five-year term. After the initial period, the FRDA is subject to a new interest rate for the next period. The new current interest-crediting rate might be higher or lower than the previous rate, but it can't drop below the guaranteed minimum interest-crediting rate.

Example: The Tandem Insurance Company offers a guaranteed minimum interest-crediting rate of 0.50% on its FRDAs. Tandem provides different current interest-crediting rates, depending on whether the contract owner chooses a three-year, four-year, or five-year term:

3 Years	4 Years	5 Years
1.35%	1.40%	1.50%

Payout Period Guarantees

Contract owners who decide to annuitize their FRDAs can select from any of the payout options we discussed in the previous lesson. FRDAs contain payout schedules, which guarantee a minimum monthly annuity payment per \$1,000 of accumulated value. (The actual payout factors used at annuitization may be more than these minimums.)

Below is a sample payout schedule for an FRDA. (Scroll left/right and up/down to see entire table, if needed.)

Minimum Monthly Annuity Payments for Each \$1,000 of Accumulated Value

Female Annuitant's Age	Life Annuity	Life Annuity with 10 Years Certain	Life Annuity with 15 Years Certain	Life Annuity with 20 Years Certain
40	\$4.13	\$4.12	\$4.11	\$4.09
45	4.36	4.34	4.32	4.28
50	4.65	4.62	4.58	4.52
55	5.05	4.99	4.91	4.82
60	5.56	5.45	5.32	5.14
65	6.27	6.07	5.82	5.48
70	7.33	6.89	6.38	5.76
75 & over	8.95	7.89	6.87	5.92

NOTE: This is an example only.

Notice how the payout factors *decrease* as you move from left to right.

Why is that?

Insurers have to charge more for contracts containing guarantees, such as ensuring payments for a specified time—so, for the contract owner, this translates into a *smaller* payout factor.

Remember how we determined the amount of each annuity payment for a SPIA? We used this formula:

Immediate annuity payment = (Single premium ÷ 1,000) × Payout factor

For an FRDA, the basic formula for determining the amount of each annuity payment is

FRDA payment = (Accumulated value ÷ 1,000) × Payout factor

Example: Remember Faye’s friend, Angela? Angela ended up purchasing an FRDA with her inheritance. At age 65, she decided to annuitize the contract, which then had an accumulated value of \$300,000. She chose the life annuity with 15 years certain, so the payout factor was 5.82.

Analysis: Angela will receive monthly payments of \$1,746.00, found as follows:

Annuity payment = (\$300,000 ÷ 1,000) × 5.82

= \$300 × 5.82

= \$1,746.00

Most FRDAs specify that, when the insurer begins making annuity payments, the amount of each payment won't change for the time period specified. Having a dependable income allows for better budgeting of expenses. However, clients living on a fixed income may experience a loss of purchasing power during periods of inflation. Some FRDAs offer a cost-of-living adjustment (COLA) rider or have a built-in auto increase feature to help protect against the effects of inflation.

Naomi Brandt bought an FRDA from the Tandem Insurance Company. Select the true statements about her annuity.

- ☒ Naomi chose an FRDA to grow her principal.
- ☒ Naomi's FRDA helps her to avoid market risk.
- ☒ Tandem guarantees a minimum interest-crediting rate on Naomi's annuity.

- The current interest-crediting rate can be higher or lower than the previous rate, but it can't drop below the guaranteed minimum interest-crediting rate stated in the contract.

Que. Hector Linares has decided to annuitize his FRDA and has chosen the life annuity with 20 years certain option. The payout factor the insurer uses in this situation is (**smaller / larger**) than the payout factor for a life annuity option.

Ans: Insurers have to charge more for contracts containing guarantees. Because Hector’s annuity guarantees payments to either Hector or a beneficiary for at least 20 years, the payout factor is smaller than if he had chosen a life annuity, where payments would cease upon his death.

Other Types of Fixed Annuities

Learning Objectives: Explain how fixed indexed annuities (FIAs) differ from traditional FRDAs.

Explain how a fixed deferred annuity with a market value adjustment (MVA) works.

Explain how deferred income annuities (DIAs) and qualified longevity annuity contracts (QLACs) differ from FRDAs and immediate annuities.

Que. Fixed-rate deferred annuities provide principal guarantees. Another type of annuity is a fixed indexed annuity, or FIA. Do you think an FIA provides a principal guarantee?

Ans: Because it's a type of fixed deferred annuity, an FIA provides a principal guarantee, but it also offers the potential for more earnings, as you will see.

Fixed Indexed Annuities

Fixed indexed annuities (FIAs) offer principal guarantees and a guaranteed minimum interest-crediting rate during the accumulation period. In addition, FIAs offer the possibility of additional earnings based on changes in an [index](#). A commonly used index in FIAs is the Standard & Poor's (S&P) 500 composite stock price index. The index specified in an FIA is known as the [reference index](#).

Fixed indexed annuity (FIA): A type of fixed deferred annuity that offers principal and interest-rate guarantees, as well as the possibility of additional earnings based on changes in an index.

Index: A statistical measurement system that tracks the performance of a group of similar investments.

Reference index: The index specified in a fixed indexed annuity contract, variations in which determine whether interest credits are earned.

Interest credits: Monetary credits earned on premiums that are determined according to a specified index-crediting mechanism that tracks changes in the reference index.

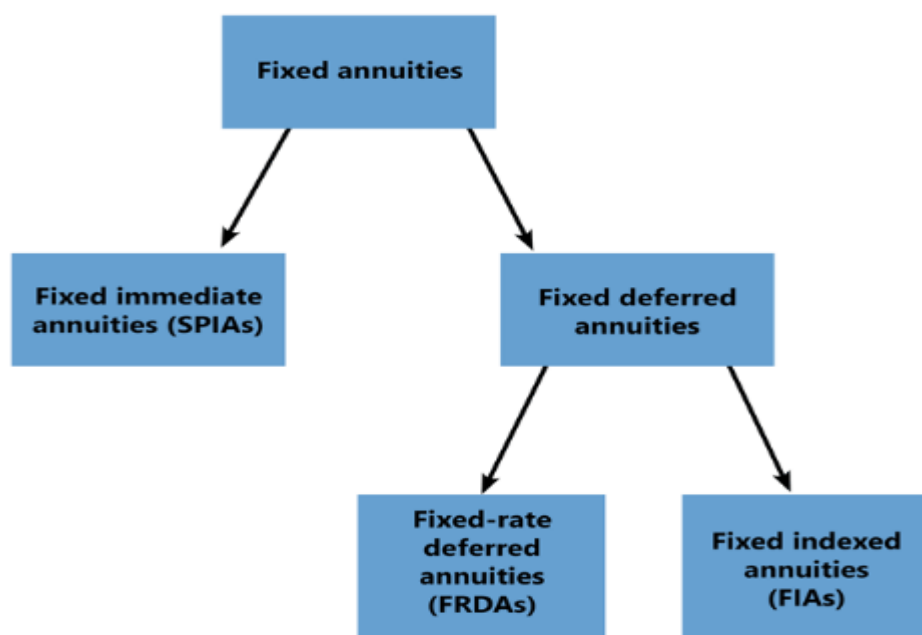
How Does This Work?

Depending on the performance of the reference index, an FIA may earn [interest credits](#). Most FIAs credit interest on an annual basis. As a general rule,

- If the reference index gains in value over the year, an annuity will earn interest credits
- If the reference index shows no growth or loses value over the year, an annuity will not earn interest credits

To compensate the insurer for these guarantees and for the costs of administering the product, the FIA contract typically limits the amount of interest credits that may be earned.

The figure below illustrates the fixed annuities we have discussed so far.



Market Value Adjustments

In some cases, an insurer imposes a [market value adjustment \(MVA\)](#) on a surrender or a withdrawal from a fixed deferred annuity—whether it's an FRDA or an FIA.

During the surrender charge period of an annuity with an MVA, if a contract owner...

- Surrenders the contract **or**
- Makes withdrawals in excess of the limits specified in the contract

... then an MVA is applied to the surrender value or the withdrawal amount in addition to the surrender charge. This adjustment can result in an increase, a decrease, or no change in the surrender value or withdrawal amount, depending on the current interest-rate environment.

More on MVAs

The amount of an MVA typically is based on changes in the benchmark interest rate, such as the rate on the 10-year U.S. Treasury bond, from the annuity purchase date to the date of the withdrawal or surrender. If the interest rate chosen for the MVA has

- **Fallen**, the MVA is **positive**, and the surrender value or excess withdrawal amount will increase
- **Risen**, the MVA is **negative**, and the surrender value or excess withdrawal amount will decrease

Example: John Kinnear owns an FRDA with an MVA, and his annuity is still in the surrender charge period. John has decided to surrender the contract to take advantage of higher market interest rates.

Analysis: Because the interest rate chosen for the MVA has risen, the MVA is negative, which means the insurer will decrease the surrender value of John's annuity.

Fixed deferred annuities with MVAs must meet certain regulatory guidelines to be issued as fixed annuities in the United States.

Deferred Income Annuities and Qualified Longevity Annuity Contracts

Despite its name, the [deferred income annuity \(DIA\)](#) is not a deferred annuity—and neither is a [qualified longevity annuity contract \(QLAC\)](#), which is a variation of a DIA. DIAs and QLACs possess features of immediate annuities and FRDAs:

- Like immediate annuities, DIAs and QLACs have no accumulation period and therefore no accumulated value. At the time of purchase, the buyer locks in a guaranteed payment amount at a future date.
- Like FRDAs, the date when payments will begin is at some point in the future—from 12 months to 40 years or more after purchase. Unlike FRDAs, though, DIAs and QLACs specify this date.

Deferred income annuity (DIA): A fixed annuity bought in the years leading up to retirement that, at the time of purchase, locks in a guaranteed stream of income to begin at some specified future time.

Qualified longevity annuity contract (QLAC): A fixed annuity that a person buys at or near retirement for a lump sum that, at the time of purchase, locks in a guaranteed stream of income to begin at an advanced age, typically at least age 80. Also known as an advanced life deferred annuity (ALDA).

Deferred Income Annuities

A DIA is generally used in retirement to provide part of a retiree's income. Many DIAs give the owner flexibility after purchase to change the date that annuity payments begin. Some contracts allow cost-of-living adjustments, although they come with smaller initial annuity payments.

Many newer DIAs offer death benefits, but they come with the cost of noticeably lower annuity payments.

Example: Brian Adolphi is 60 and just bought a DIA. Annuity payments are scheduled to begin in 7 years when he retires at 67 and will continue for the rest of his life. Brian's DIA has no death benefit.

Analysis: If Brian dies at 65, he'll never receive any annuity payments. If he dies at 68, he'll receive only a year of payments, and no one else will receive any money after that. On the other hand, if Brian lives to be 90, he'll have received payments for 23 years, and these payments will have been larger than those for a traditional FRDA.

Qualified Longevity Annuity Contracts

People often worry about running out of money in their later years because they don't know how long they will live. Will they live for twenty, thirty, or more years in retirement? By using a portion of their assets to purchase a QLAC, people will have a dependable income stream in their later years.

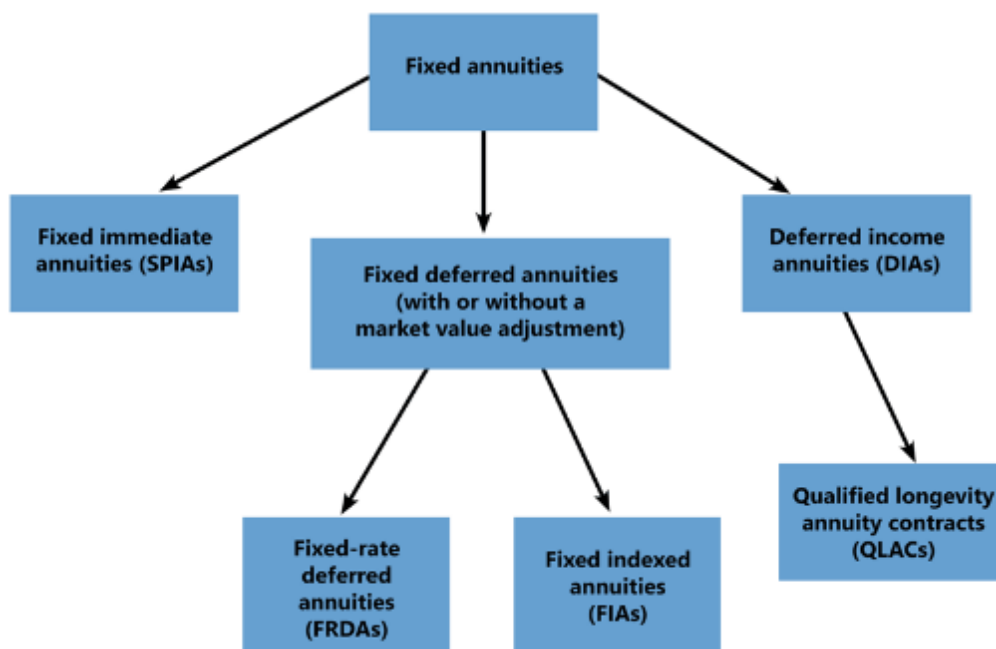
QLAC annuity payments do not begin until an advanced age, such as 80. As a result, the annuity payments the person receives from a QLAC will be quite large compared to FRDA payments bought for the same premium amount. As with DIAs, contract owners of QLACs can choose a death benefit feature, but the income payments will be lower.

Note that, unlike the other types of annuities we discuss in this lesson, a QLAC can only be offered through a qualified retirement plan. We discuss the differences between qualified and nonqualified annuities in the next lesson.

Example: At age 65, Manny Iruku has substantial funds in a brokerage account. He's concerned about outliving his assets, though, so he decides to buy a QLAC that will begin making payments when he turns 80. Manny pays for the annuity with a single premium of \$50,000.

Analysis: Manny will find it easier to plan for his income needs from age 65 to 80 because he knows that he has another source of income that will start at age 80.

The figure below summarizes the different types of fixed annuities.



Que. Assume that the reference index for a given fixed indexed annuity (FIA) lost value over the interest-crediting term. In this situation, the contract owner would lose some of the premiums invested in the contract.

Ans: In this situation, the FIA would not earn any interest credits over the term. As a fixed annuity, however, the FIA would guarantee no loss of principal.

Que. Assume that the owner of a fixed deferred annuity with a market value adjustment (MVA) decides to surrender the contract at a time when the interest rate chosen for the MVA is higher than when the contract was issued. In this situation, the insurer will (**decrease / increase**) the surrender value.

Ans: Because the interest rate chosen for the MVA is higher than when the contract was issued, the insurer will decrease the surrender value. Conversely, if an excess withdrawal or a surrender occurs at a time when the interest rate chosen for the MVA is lower than when the contract was issued, the insurer will increase the withdrawal or surrender value.

Select the true statements about deferred income annuities (DIAs) and qualified longevity annuity contracts (QLACs).

- ☒ For DIAs and QLACs, the buyer locks in a guaranteed source of retirement income that will begin at a future date.
- ☒ Unlike fixed-rate deferred annuities, DIAs and QLACs specify the date when payments will begin.
- ☐ Like deferred annuities, DIAs and QLACs have an accumulation period and an accumulated value.
- ☒ Both DIAs and QLACs are categorized as fixed annuities but not deferred annuities.

Introduction to Variable Annuities

Learning Objective: Describe the features that distinguish variable annuities from traditional FRDAs, and explain how insurers determine the accumulated value of a variable annuity.

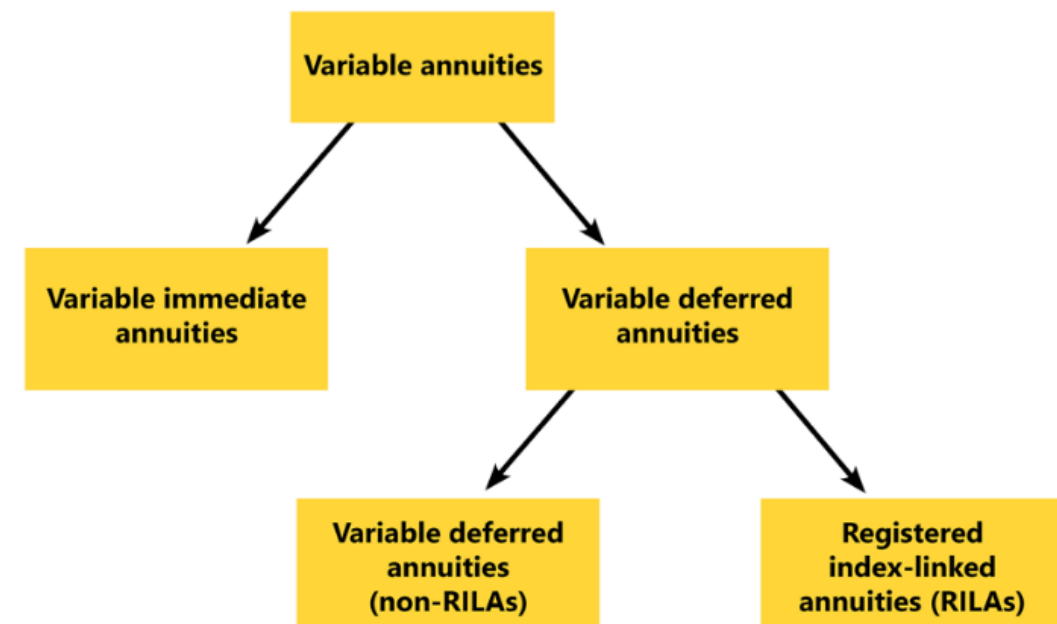
A variable annuity offers fewer guarantees than a fixed annuity. In the absence of a living benefit rider, a variable annuity offers no principal guarantee. (We discuss living benefit riders later in this lesson). On the other hand, a contract owner who is willing to take some risk in how premiums are invested may be able to grow the principal.

Variable Annuities

Traditional variable annuities provide contract owners with investment choice—but along with that investment choice comes the possibility of investment losses. Because of the risk of investment losses, variable annuities must be registered as securities with the Securities and Exchange Commission (SEC).

In recent years, a newcomer has emerged in the variable annuity space: the registered index-linked annuity, or RILA. RILAs operate a bit differently from traditional variable annuities. We discuss RILAs later in this lesson. Until then, when we say *variable annuity*, we are referring to a *variable deferred annuity* other than a RILA.

The chart below summarizes the types of variable annuities. Variable immediate annuities are rare, so our discussion will focus on the more common product—the variable deferred annuity.



With a [variable annuity](#), the following amounts may vary according to market performance:

- The accumulated value
- The annuity payments for contract owners choosing to receive variable annuity payments
- Any withdrawal amounts or annuity payments made under the terms of a living benefit rider

Investment Choice

Within limits, a variable annuity contract owner is free to choose the accounts into which premiums are invested. Click or touch each type of account below to learn more.

1. [Fixed accounts](#) are backed by the insurer's general account, where they accumulate interest at the specified current interest rate, but no lower than the guaranteed minimum interest rate. The insurer bears the investment risk for these fixed accounts.
2. [Subaccounts](#) are investment options resembling mutual funds. Like mutual funds, each subaccount consists of a pool of investments with a distinct risk-return profile. For example, a subaccount seeking significant growth in the principal usually involves a higher level of risk. Subaccounts are maintained apart from an insurer's general account in [separate account portfolios](#). When subaccount values increase, the annuity contract owner—and **not** the insurer—benefits. The contract owner also bears the investment risk when these values decrease. If subaccount values decrease significantly, contract owners even run the risk of losing part of their principal.

variable annuity: An annuity under which the amount of the accumulated value and the amount of the annuity payments may fluctuate in accordance with the performance of one or more specified investment funds.

Fixed account: For variable deferred annuities and fixed indexed annuities (FIAs), a fund that offers a guaranteed rate of interest.

Subaccount: An investment fund within an insurance company's separate account portfolio. Also known as a fund option or a unit-linked fund.

Separate account portfolio: For an insurer, a portfolio of assets that supports such products as variable life insurance and variable annuities. Also known as a segregated account portfolio and unit-linked portfolio.

Accumulation unit: An ownership share in a selected subaccount of a separate account portfolio held during the accumulation period of a variable deferred annuity.

Changing Investment Choices

Within stated limitations, contract owners have flexibility in their investment choices. A contract owner can

- Change the percentage of money allocated to fixed accounts and subaccounts
- Transfer funds between fixed accounts and subaccounts

An attractive feature associated with variable annuities is that, during the accumulation period, any transfer of funds among fixed accounts and subaccounts will not trigger a tax liability for the contract owner.

Accumulated Values for Variable Annuities

With variable annuities, contract owners can use their premiums to purchase [accumulation units](#), which represent ownership shares in the selected subaccounts. The insurer normally subtracts certain expense charges from these premiums.

The number of accumulation units that a given amount will purchase depends on the accumulation unit value of the subaccount at that time.

Confused?

Here are the formulas insurers use to calculate the accumulated value of a variable annuity:

$$\text{Current Value of an Accumulation Unit} \times \text{\# of Accumulation Units in the Subaccount} = \text{Contract Owner's Subaccount Value}$$

$$\text{Total of All Subaccount Values} + \text{Fixed Account Values} = \text{Contract's Total Accumulated Value}$$

Example: On June 1, David Croft purchased a \$10,000 variable annuity from the Tandem Insurance Company. He directed the insurer to invest \$6,000 of his premium in Subaccount A and the remaining \$4,000 in Subaccount B. The current values of the accumulation units for each subaccount are shown below:

Subaccount A

Accumulation units =
\$20 per unit

Subaccount B

Accumulation units =
\$25 per unit

So, David's premium bought 300 accumulation units in Subaccount A (\$6,000 ÷ \$20), and 160 units in Subaccount B (\$4,000 ÷ \$25).

One month later on July 1, the price of accumulation units in Subaccount A had increased to \$22, and the value of accumulation units in Subaccount B had decreased to \$24. (Note that this example doesn't take into account fees and charges.)

Let's see how this affected the value of David's subaccounts. First, we'll look at Subaccount A.

Subaccount A

Date	Value of Accumulation Unit	x	# of Accumulation Units in Subaccount	=	Subaccount Value
June 1	\$20		300		\$6,000
July 1	\$22		300		\$6,600

So, on July 1, David had earned \$600 in this subaccount, which is a 10% profit ($\$600 \text{ gain} \div \$6,000 \text{ initial investment} = 0.10$).

Now let's look at Subaccount B.

Subaccount B

Date	Value of Accumulation Unit	x	# of Accumulation Units in Subaccount	=	Subaccount Value
June 1	\$25		160		\$4,000
July 1	\$24		160		\$3,840

As of July 1, the value of this subaccount had decreased by \$160, which is a 4% loss ($\$160 \text{ loss} \div \$4,000 \text{ initial investment} = -0.04$).

Now that we know the value of each subaccount, we can calculate the *accumulated* value of David's subaccounts as of July 1...

$$\begin{aligned}
 \text{Accumulated Value} &= \text{Value of Subaccount A} + \text{Value of Subaccount B} \\
 &= \$6,600 + \$3,840 \\
 &= \$10,440
 \end{aligned}$$

So, the accumulated value of David's subaccounts on July 1 was \$10,440. Overall, David earned a positive return on his \$10,000 investment.

Now let's see how his subaccount investments were doing two months later...

Two months later on September 1, the price of accumulation units in Subaccount A had decreased to \$19 but the value of accumulation units in Subaccount B had remained at \$24.

Let's see how this affected the value of David's subaccounts, starting with Subaccount A.

Subaccount A

Date	Value of Accumulation Unit	x	# of Accumulation Units in Subaccount	=	Subaccount Value
June 1	\$20		300		\$6,000
July 1	\$22		300		\$6,600
September 1	\$19		300		\$5,700

So, on September 1, David had lost \$900 in this subaccount, which is a 14% loss ($\$900 \text{ loss} \div \$6,600 \text{ initial investment} = -0.14$).

Now, let's look at Subaccount B.

On September 1, David had the same amount of money in this subaccount as on July 1: \$3,840.

Subaccount B

Date	Value of Accumulation Unit	x	# of Accumulation Units in Subaccount	=	Subaccount Value
June 1	\$25		160		\$4,000
July 1	\$24		160		\$3,840
September 1	\$24		160		\$3,840

So, now we can calculate the *accumulated* value of David's subaccounts on September 1...

$$\begin{aligned}
 \text{Accumulated Value} &= \text{Value of Subaccount A} + \text{Value of Subaccount B} \\
 &= \$5,700 + \$3,840 \\
 &= \$9,540
 \end{aligned}$$

Because of the drop in the value of Subaccount A's accumulation units, David's Subaccount A investment on September 1 was \$900 less than it had been on July 1.

Even though the value of his Subaccount B investment remained stable, the *accumulated* value of his contract had dropped below his initial \$10,000 investment.

Que. A contract owner who chooses to annuitize a variable annuity has the same payout options as a fixed annuity contract owner. In addition to selecting a payout option, variable annuity contract owners can choose fixed or variable payments. Do you think they typically choose fixed annuity payments or variable annuity payments?

Ans: Fixed payments are more popular because contract owners typically prefer a predictable income stream.

Although contract owners who annuitize are usually looking for predictable income, variable payments may be appropriate for someone who can tolerate risk and market volatility. One advantage of variable payments is that they may offer some protection against inflation risk.

Variable annuity contract owners can also select a combination of fixed and variable annuity payments—for example, half of each payment is fixed, while the other half fluctuates.

Remember, though—few deferred annuity owners choose annuitization.

Que. On August 1, Gerald Logan paid a single premium of \$100,000 for a variable annuity from the Tandem Insurance Company. Gerald chose to split his premium between two subaccounts—investing \$60,000 in Subaccount A and \$40,000 in Subaccount B. At the time of purchase, the price of one accumulation unit in

- Subaccount A was \$25
- Subaccount B was \$20

One month later, on September 1, the price of one accumulation unit in

- Subaccount A was \$23
- Subaccount B was \$21

(Gerald / Tandem) bears the investment risk associated with this annuity. As of September 1, the accumulated value of Gerald's annuity had (**decreased by \$2,800 / increased by \$1,000**).

Ans: Gerald invested only in subaccounts, so he bears the investment risk associated with this annuity. As of September 1, the accumulated value of his annuity decreased by \$2,800, found as follows:

On August 1, Gerald purchased

- 2,400 units in Subaccount A, calculated as $\$60,000 \div \25
- 2,000 units in Subaccount A, calculated as $\$40,000 \div \20

On September 1, the value of Gerald's investment in

- Subaccount A = $2,400 \times \$23$, or \$55,200
- Subaccount B = $2,000 \times \$21$, or \$42,000

So, the accumulated value = $\$55,200 + \$42,000$, or \$97,200, which represents a loss of \$2,800.

Variable Annuity Riders and Charges

Learning Objectives: Describe the death benefit and living benefit riders that variable annuities offer. Describe the charges insurers impose on variable annuities.

Que. Many insurers offer supplemental benefits—such as death benefit and living benefit riders—that variable annuity contract owners can purchase. When do you think these benefits apply?

Variable Annuity Riders

Insurers use [policy riders](#) to amend variable annuity contracts to provide supplemental benefits. The two main types of supplemental benefits are death benefits and living benefits.

Death Benefit Riders

A [guaranteed minimum death benefit \(GMDB\)](#) guarantees that the insurer will pay the beneficiary at least a specified minimum amount, regardless of the contract's accumulated value at the time. Insurers offer many variations on the GMDB, but the typical one is a return of premiums less any withdrawals.

Policy rider: In the context of an annuity contract, a form attached to the contract that changes or amends the contract's provisions. The policy rider becomes part of the contract and either expands or limits the benefits payable under it. Also known as an endorsement or a rider.

Guaranteed minimum death benefit (GMDB): A variable annuity rider that guarantees that, if the annuitant dies before annuity payments begin, the beneficiary will receive at least a stated minimum amount, regardless of the contract's accumulated value at that time.

Example: Elena Takayashi paid a single premium of \$300,000 for a variable annuity with a GMDB. This GMDB guaranteed that the beneficiary—her husband, Martin—would receive at least a return of premiums less any withdrawals. When Elena died, she had taken no withdrawals. The current accumulated value of her contract had fallen to \$250,000 due to market performance.

Analysis: The insurer paid Martin a death benefit of \$300,000, which was \$50,000 more than he would have received if Elena had not purchased the GMDB.

Living Benefit Riders

Contract owners of variable annuities may have the option of purchasing *living benefit riders*, which offer protection from market downturns by guaranteeing certain income, withdrawal, or accumulation amounts. Owners of other types of deferred annuities—such as FIAs and FRDAs—may also be able to purchase a living benefit rider.

The guaranteed income or withdrawal amounts depend on the contract's *benefit base*, which is a value that the insurer calculates separately from the contract's accumulated value. This benefit base is typically protected from any

decreases in the financial markets. For a product like a variable annuity, where the accumulated value fluctuates based on the underlying investments, having a protected value—i.e., the benefit base—can give the contract owner peace of mind.

Click or touch each type of major living benefit rider below to learn more.

Guaranteed minimum income benefit (GMIB)

A [guaranteed minimum income benefit \(GMIB\)](#) guarantees a minimum annuity payment amount for life based on the annuitization of the benefit base. Typically, the contract owner must keep the annuity in force for a certain number of years during the accumulation period, which is known as the "waiting period," before having the option to annuitize.

Guaranteed lifetime withdrawal benefit (GLWB)

A [guaranteed lifetime withdrawal benefit \(GLWB\)](#) allows the owner to take guaranteed withdrawals for life without annuitizing the contract. With a GLWB, the accumulated value can be completely depleted and the contract owner would still be entitled to the guaranteed lifetime withdrawal amounts.

Guaranteed minimum withdrawal benefit (GMWB)

A [guaranteed minimum withdrawal benefit \(GMWB\)](#) guarantees that a contract owner may withdraw annually a specified percentage of the benefit base. Although the withdrawal amounts are not guaranteed for life, investors can effectively use a GMWB to provide guaranteed income for a certain period, while retaining control over the assets and remaining invested in the market.

Guaranteed minimum accumulation benefit (GMAB)

A [guaranteed minimum accumulation benefit \(GMAB\)](#) guarantees a minimum protected amount if the annuity stays in force for a specified period of time.

An important aspect of the GMAB is that it operates automatically. While the owner of a contract with a GMIB, GLWB, or GMWB must choose to utilize the withdrawal or income benefit, the insurer provides the GMAB to the owner if the protected amount exceeds the accumulated value at the end of the specified period.

Guaranteed minimum income benefit (GMIB): A living benefit rider that guarantees a minimum annuity payment amount for life based on the annuitization of a protected value—known as the "benefit base"—regardless of the investment performance of the accumulated value.

Guaranteed lifetime withdrawal benefit (GLWB): A living benefit rider that guarantees annual withdrawals of a specified percentage of a protected value—known as the "benefit base"—for life without annuitizing the contract.

Guaranteed minimum withdrawal benefit (GMWB): A living benefit rider that guarantees that, during the accumulation period, a contract owner may withdraw annually a specified percentage of a protected value—known as the "benefit base"—regardless of the investment performance of the accumulated value.

Guaranteed minimum accumulation benefit (GMAB): A living benefit rider that guarantees the contract owner will always have a minimum protected amount if the annuity stays in force for a specified period of time, regardless of the investment performance of the accumulated value.

Interest spread: For fixed deferred annuities and any fixed accounts offered in variable deferred annuities, the share of investment earnings that the insurer retains to either pay expenses or provide a profit.

Que. Andrew Yates purchased a variable annuity with a guaranteed minimum death benefit (GMDB) from Jardim Insurance and named his wife, Flora, as the beneficiary. Which statements are true about this situation?

- ☒ A GMDB guarantees that Jardim will pay Flora at least a specified minimum amount, regardless of the contract's accumulated value at the time of Andrew's death.
- ☐ Jardim pays the GMDB only if Andrew dies after annuitizing the contract.
- ☒ Insurers like Jardim offer many variations on the GMDB, including all premiums paid, less withdrawals.

That's correct!

A GMDB does guarantee that Jardim will pay Flora at least a specified minimum amount, and insurers like Jardim offer many variations on the GMDB. However, Jardim pays the GMDB only if Andrew dies during the annuity's accumulation period.

Ans:

Of the following living benefit riders, which one bases the annuity payment amounts on annuitization of the benefit base?

- ☐ Guaranteed minimum withdrawal benefit (GMWB)
- ☐ Guaranteed minimum accumulation benefit (GMAB)
- ☐ Guaranteed lifetime withdrawal benefit (GLWB)
- ☒ Guaranteed minimum income benefit (GMIB)

That's correct!

Of these four living benefit riders, only the GMIB bases the annuity payment amounts on annuitization of the benefit base. Typically, the contract owner must keep the annuity in force for a certain number of years during the accumulation period, which is known as the "waiting period," before having the option to annuitize.

Note: Variable annuities have more explicit charges than do fixed deferred annuities. Let's see why.

Charges for Deferred Annuities

Recall that all deferred annuities—including variable annuities—are subject to surrender charges. For variable annuities, the surrender charge is usually called a *contingent deferred sales charge*, or *CDSC*.

Expense Charges for Variable Annuities

Unlike the other types of deferred annuities we have discussed so far, variable annuities come with explicit expense charges.

Why is that?

For fixed deferred annuity products, insurers cover their expenses and earn profits through something called an **interest spread**—basically, the difference between the return the insurer gets by investing the premiums and the interest credited to the annuity. Remember that? It's called the *current interest-crediting rate*.

Except for any interest spread on a fixed account, variable deferred annuities don't have an interest spread. Any investment gains go to the contract owner. So, the insurer assesses explicit charges to cover the expenses associated with the product and provide a profit.

Some of these charges are assessed as a percentage of a specified value, such as the contract's accumulated value, the average daily balance of the contract's value over the time period, the contract's benefit base (when a living benefit rider applies), or some other value specified by the insurer. For simplicity in this section, we use the accumulated value as the specified value.

Click or touch each tab below to learn which types of variable annuity charges insurers are required by law to disclose

Administrative Charge

An [administrative charge](#), which covers the costs of performing certain activities, such as creating records, making changes to contracts, and making transfers among variable annuity subaccounts. Administrative charges are typically assessed annually as a percentage of the contract's accumulated value.

Contract Maintenance Charge

A [contract maintenance charge](#), which is typically a flat dollar amount per month, per quarter, or per year. Insurers generally waive this charge if the contract's accumulated value is greater than a specified amount, such as \$50,000.

Front-End Load

A [front-end load](#), which is calculated as a percentage of any premium payments. Insurers assess this charge to pay commissions to the financial professionals who sell these annuities. Most variable annuities sold today do not assess front-end loads, as they were very unpopular with customers. If a variable annuity does have a front-end load, it won't have a surrender charge.

Mortality and Expense (M&E) Charge

A [mortality and expense \(M&E\) charge](#), which, like the administrative charge, is generally assessed annually as a percentage of the accumulated value. Mortality risks include the risk that annuitants receiving annuity payments will live longer than the insurer assumed when pricing the product; or that death benefits paid will exceed the annuity's accumulated value. The expense risks in this charge cover the insurer's obligation to administer the contract.

Fund Operating Expense Charge

A [fund operating expense charge](#), which is assessed at the subaccount or fund level to cover the advisory and administrative services that the fund manager provides. Each fund has its own separate operating expense charge. The fund manager subtracts the fund's charge from the fund's returns.

Service Fee

A [service fee](#), which is a charge for specific services or transactions. For example, an insurer will assess a service fee if a contract owner transfers funds between subaccounts more times than the contract allows in a year.

Rider Charge- A [rider charge](#), which applies when a contract owner has selected a living benefit rider.

Administrative charge: For a variable deferred annuity, a periodic charge the insurer levies to cover the costs of administering the contract.

contract maintenance charge: For a variable deferred annuity, a periodic charge the insurer assesses to cover the general expenses incurred in maintaining the contract.

front-end load: For a variable deferred annuity, a fee the insurer charges when the contract owner purchases or makes additional contributions to the annuity; this fee helps cover the insurer's expenses of selling the annuity. Also known as a front-end sales charge.

mortality and expense (M&E) charge: For a variable deferred annuity, a fee designed to cover various risks and expenses assumed by the insurer in pricing the product, such as the risk involved in providing the death benefit and certain other guarantees. Often abbreviated as an M&E charge.

fund operating expense charge: For each fund offered in a variable deferred annuity, a charge assessed by the fund manager to cover the advisory and administrative services provided by the manager.

service fee: A charge an insurer assesses for specific services or transactions requested by the owner.

rider charge: For a variable annuity, a charge an insurer assesses to cover the risks of providing a living benefit rider. Also known as a rider premium.

Except for any surrender charges, each of the above charges is set at contract issue and does not change while the contract is in force. For example, if a variable annuity contract specifies an administrative charge of 0.10%, assessed annually against the contract's accumulated value, this percentage will remain the same during the contract's life. To get a sense of how all the different charges work with a variable annuity, let's look at an example.

Example: Four years ago, Sharon Baumer bought a variable annuity with a GLWB from the Tandem Insurance Company. Her annuity has the following charges:

- An administrative charge of 0.10%, assessed annually against the contract's accumulated value
- A contract maintenance charge of \$50 annually (waived when the accumulated value reaches \$50,000)
- An M&E charge of 1.15%, assessed annually against the contract's accumulated value
- A CDSC for the first five years of 7%, 7%, 6%, 5%, and 3%
- A fund operating expense charge for each subaccount, which is subtracted from the subaccount's returns
- For the GLWB, a charge of 1.30%, assessed annually against the contract's accumulated value

At the end of last year, Sharon's annuity had an accumulated value of \$500,000 and was assessed the following charges:

Charges for Sharon's Variable Annuity		
Administrative charge	$0.10\% \text{ of } \$500,000 = 0.0010 \times \$500,000$	\$500
Contract maintenance charge	Waived, because accumulated value > \$50,000	\$0
M&E charge	$1.15\% \text{ of } \$500,000 = 0.015 \times \$500,000$	\$7,500
CDSC	N/A	\$0
Fund operating expense charges	Total for all subaccounts = \$5,000	\$5,000
GLWB	$1.30\% \text{ of } \$500,000 = 0.013 \times \$500,000$	\$6,500
Total Charges		\$19,500

So, for last year, the total charges for Sharon's contract were 3.9% of the contract's accumulated value, found as $\$19,500 \div \$500,000$. Note that a significant portion of the charges—33%, found as $\$6,500 \div \$19,500$ —covers the contract's insurance benefits, in the form of the GLWB.

Which of the following types of annuities typically come with surrender charges? (Choose all that apply.)

☒ Fixed indexed annuities (FIAs)

☒ Fixed-rate deferred annuities (FRDAs)

☒ Variable deferred annuities

That's correct!

All of these annuities are types of deferred annuities. Deferred annuities, whether they're fixed or variable, typically come with surrender charges.

Que. Lenny Sutton owns a variable annuity from the Tandem Insurance Company. Tandem assesses a charge on Lenny's annuity that compensates Tandem for the cost of providing death benefits and other guarantees under the contract. This charge is known as a

Ans: The **mortality and expense (M&E) charge** is generally assessed as a percentage of the contract's accumulated value. Mortality risks include the risk that annuitants will live longer than the insurer assumed when pricing the product; or that death benefits paid will exceed the annuity's accumulated value. The expense risks in this charge cover the insurer's obligation to administer the contract.

RILAs: The New Kid on the Block

Learning Objectives: Compare and contrast a registered index-linked annuity (RILA) with a traditional variable annuity and a fixed indexed annuity (FIA).

Apply the risk-return trade-off to the different types of deferred annuities.

Que. Insurers have created a variable product called a registered index-linked annuity (RILA). How do you think a RILA differs from a traditional variable annuity?

Ans: Although RILAs are variable products, premiums for them go in the insurer's general account. Unlike traditional variable annuities, RILAs do not have subaccounts. Let's take a closer look.

RILAs

In recent years, [registered index-linked annuities \(RILAs\)](#) (A type of variable annuity that offers an investment option linked to a specific index. Also known as an indexed variable annuity (IVA), a structured annuity, and a buffered annuity.) have become popular with customers seeking equity market exposure combined with some protection against investment losses. As the word "registered" indicates, a RILA must be registered as a security, just like a traditional variable annuity.

RILAs resemble FIAs in the following ways:

- The insurer invests RILA premiums in its general account.
- RILAs offer the potential for principal growth based on the performance of a stock market index, such as the S&P 500, over a specified term, such as one year or more. Also like FIAs, this growth is subject to specified limits—sometimes called *caps* or *participation rates*.

Because RILAs are variable annuities, though, contract owners can lose money on them. Recall that a variable annuity contract owner can lose money if the underlying investments—or subaccounts—perform poorly.

Although RILAs don't have subaccounts, they do have an investment component—because principal growth is affected by the performance of an associated stock market index. With a RILA, the contract owner can lose money based on decreases in the value of the stock market index.

However, unlike traditional variable annuities, RILAs offer contract owners some protection against excessive investment loss by using **buffers** or **floors**. Click or touch each tab below to learn more.

Buffer: With a *buffer*, the accumulated value is protected until index losses exceed a specified limit, such as 10%, 15%, or 20%. For example, with a 10% buffer, if the value of the index decreases by 15%, you would lose 5%.

Floor: With a *floor*, the accumulated value is protected from index losses in excess of a specified percentage, such as 10%. For example, with a 10% floor, if the value of the index decreases by 15%, you would lose 10%.

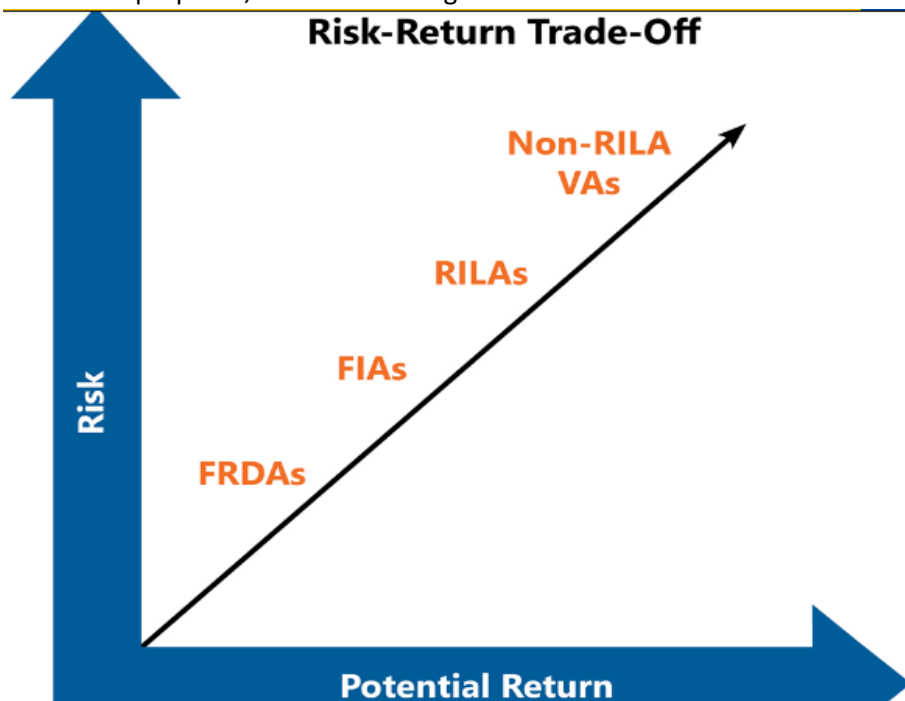
For simplicity, we are assuming that the contract owner selects just one buffer or floor. In reality, with most RILAs, owners can divide their premium(s) between different buffer and floor options.

Because RILAs are deferred annuities, they come with surrender charges.

Risk-Return Trade-Off for Deferred Annuities

Clients purchase deferred annuities to grow a principal amount through investment returns. In general, the greater the investment risk, the greater the investment return—a concept known as the *risk-return trade-off*.

The following graph presents the risk-return trade-off for the types of deferred annuities we've discussed. For illustrative purposes, we are assuming the annuities have no death benefit or living benefit riders.



- FRDAs, with their principal and interest-rate guarantees, increase the accumulated value over time, so they have little risk but also relatively low potential returns.
- Then come FIAs, which are riskier than FRDAs but offer more potential for principal growth because of the potential for additional earnings based on changes in an index.
- Then come RILAs, with greater potential for growth—but also greater potential investment losses.
- At the far right are variable annuities other than RILAs, which have the greatest potential returns but also the greatest investment risks.

Que. Valerie Jordan purchased a RILA from the Tandem Insurance Company. At the end of the term, the index dropped 15% in value, and the accumulated value of Valerie's RILA decreased by 5%. This information indicates that Valerie's RILA has a

Ans: With a buffer of 10%, Valerie's RILA protects her—or buffers her—from the first 10% of any losses. She accepts any losses in excess of 10%: $15\% - 10\% = 5\%$. If she had selected a floor of 10%, the accumulated value of her RILA would have decreased by 10%.

Que. An annuity purchaser who is willing to accept unlimited risk in exchange for the greatest potential for investment gains would likely buy

Ans: Of these types of deferred annuities, a traditional variable annuity offers the greatest potential returns but also the greatest investment risks.

Qualified vs. Nonqualified Annuities

Learning Objectives:

- Define a qualified annuity and a nonqualified annuity and provide examples of each.
- Explain how annuities held in retirement plans and nonqualified annuities differ in terms of contribution limits, taxation of contributions, and distribution requirements.
- Explain how annuities held in retirement plans and nonqualified annuities differ in terms of the taxation of their distributions.
- Calculate the cost basis of a nonqualified annuity, and explain how to determine the taxable portion of (1) fixed annuity payments, (2) annuity payments for life, and (3) variable annuity payments.
- Describe how a surrender or exchange of a nonqualified annuity is treated for federal tax purposes.
- Describe situations in which taxpayers must use the earnings first rule and the cost recovery rule to calculate their taxable income, and explain how these rules affect the amount of a person's taxable income when the person withdraws funds from a nonqualified annuity.
- Explain the aggregation rule and identify situations in which the rule applies to nonqualified annuities.
- Describe the penalty taxes imposed on premature distributions from qualified and nonqualified annuities, and identify common situations in which these distributions are exempt from these tax penalties.

Introduction to Qualified and Nonqualified Annuities

Learning Objectives: Distinguish between a qualified annuity and a nonqualified annuity and provide examples of each. Explain how annuities held in retirement plans and nonqualified annuities differ in terms of contribution limits, taxation of contributions, and distribution requirements.

In the past two lessons, you learned the basics about annuities, including the different types, such as immediate versus deferred and fixed versus variable. Another important classification for annuities is based on how they are funded and where they are held, which makes them either [qualified annuities](#) (An annuity purchased to fund or distribute funds from a tax-advantaged retirement plan or an individual retirement arrangement (IRA).) or [nonqualified annuities](#) (An annuity purchased outside of a tax-advantaged retirement plan or an individual retirement arrangement (IRA).).

Packing for Retirement? Should You Take an Annuity with You? If so, What Kind?

Qualified annuities can be held in employer-sponsored retirement plans, such as 401(k) plans, 403(b) plans, and 457(b) plans. The tax-advantaged individual retirement annuity (IRA) discussed in an earlier lesson is also an example of a qualified annuity. Annuities can also be nonqualified. Nonqualified annuities are purchased outside of an employer-sponsored retirement plan or individual retirement arrangement.

- You're packing for retirement, and you're wondering whether you should take an annuity with you. And if so...what kind? Examples of qualified annuities include annuities held in employer-sponsored retirement plans, such as 401(k) plans, 403(b) plans, and 457(b) plans, as well as individual retirement annuities. Nonqualified annuities are individual annuities purchased outside of a retirement plan or individual retirement arrangement.

Que. Qualified and nonqualified annuities have similarities and differences. One difference is that **only**

Ans: All annuities, whether qualified or nonqualified, have two attributes in common: (1) they offer guaranteed income for life, and (2) they allow earnings to accumulate on a tax-deferred basis (with some exceptions, which we cover below). A primary difference between nonqualified and qualified annuities is that the IRS imposes annual contribution limits on qualified annuities.

Exceptions- Annuity earnings are not tax deferred when a non-natural person—such as a corporation, partnership, or trust—owns an annuity and the owner is not acting as an agent for a natural person. In this case, earnings credited each year on contributions made after February 28, 1986, are taxable.

Note that all the annuities we discuss in this lesson benefit natural persons—and therefore qualify for tax deferral of earnings.

In addition to the annual IRS contribution limits for qualified annuities, differences between qualified and nonqualified annuities include

- Taxation of contributions
- Requirements for distributions
- Taxation of distributions
- Exceptions for penalty taxes imposed on premature distributions

Because the tax requirements and limits for individual retirement annuities are the same as those for individual retirement arrangements—described in an earlier lesson—we will not repeat that information here.

Instead, we will cover nonqualified annuities and annuities held in retirement plans. For annuities held in retirement plans, we are referring to annuities purchased with pre-tax dollars. Annuities held in a designated Roth feature of a retirement plan are uncommon, so we do not discuss them in this lesson.

As we discuss the differences between annuities held in plans and nonqualified annuities, we will use the following examples.

Annuity Held in a Qualified Plan: Julio Godinez, age 46, participates in his employer's 401(k) plan, which has recently added a variable annuity option. Julio decides to put some of his plan contributions into the variable annuity option.

Nonqualified Annuity: Anita Stueben, age 40, does not have access to a workplace retirement plan. Anita decides to use after-tax savings to purchase a fixed-rate deferred annuity (FRDA) from a life insurer to accumulate assets for retirement.

Contribution Limits

Maximum IRS contribution limits apply to annuities held in retirement plans. These limits place caps on the amounts that individuals can contribute to an annuity in a single year.

In general, an annuity held inside a retirement plan is subject to the rules applicable to the plan in which the annuity is held. According to the IRS, for 2022, the maximum annual contribution a 401(k) plan participant under age 50 can make on a pre-tax basis is \$20,500; for a plan participant age 50 or older, the maximum annual contribution increases to \$27,000.

Example: Julio, who is under age 50, can contribute a maximum of \$20,500 to the variable annuity option in his employer's 401(k) plan.

There are ways to fund an annuity outside of these annual limits. Click or touch the following headings.

QLAC Funding

Remember QLACs, or qualified longevity annuity contracts? They represent an exception to the annual IRS contribution limits for qualified annuities. The maximum lifetime amount a participant can use to purchase a QLAC is the lesser of 25% of the total qualified retirement savings account balance and a specified maximum amount, which is adjusted periodically for inflation. In 2022, the specified maximum amount is \$140,000.

Example: Tanner Thompson contributed \$10,000 to his 401(k) plan account in 2022. The balance of the account is \$600,000. Tanner decided to use \$140,000 of the account balance to purchase a QLAC inside the plan. Tanner could

not contribute 25% of the 401(k) account balance ($0.25 \times \$600,000 = \$150,000$) because that exceeds the funding limit for a QLAC.

The transaction to purchase the QLAC is not subject to the annual IRS contribution limits, and the funds in the QLAC are still classified as qualified.

Conversion Funding

Another exception occurs when the owner of a traditional individual retirement account or a participant in a qualified retirement plan moves qualified funds to a traditional individual retirement annuity. In this case, no maximum limits apply to the amount converted, and the vehicle remains qualified.

Example: Josephine Scott, age 65, retired with a \$500,000 account balance in her company's 401(k) account. Josephine uses \$250,000 of her 401(k) account balance to purchase an individual retirement annuity. Josephine's conversion is not subject to the annual IRS contribution limits, and the funds in the new annuity are still classified as qualified because they are held within an IRA.

Owners of nonqualified annuities aren't subject to the annual IRS limits, so they can pay as much as the insurer's guidelines allow in premiums. A typical insurer limit for nonqualified annuity premium payments is \$1 million—and this limit applies in aggregate to all the annuities a contract owner has with a company. For example, if a contract owner has more than one annuity with a company, the total premiums for all the owner's annuities would be limited to \$1 million.

Example: Anita has \$400,000 in after-tax savings, all of which she can use to purchase her nonqualified FRDA.

Taxation of Contributions

Annuities held in retirement plans are usually funded with *pre-tax* dollars—whereas nonqualified annuities are always funded with *after-tax* dollars.

Example: Julio's contributions to the variable annuity option in his employer's 401(k) plan are made on a pre-tax basis, whereas Anita's single premium of \$400,000 to her nonqualified annuity is made on an after-tax basis.

Requirements for Distributions

Recall that owners of traditional IRAs—but not owners of Roth IRAs—are subject to the RMD rules. Likewise, owners of annuities held in retirement plans generally must follow these rules by beginning to take RMDs by April 1 of the year following the year in which they turn 72.

Example: Julio will be subject to the RMD rules with respect to the variable annuity option in his employer's plan.

QLAC Exceptions: When a retiree begins taking RMDs from a retirement account, the retiree does not have to include the value of a QLAC in the RMD calculation—thus reducing the amount of each RMD—as long as certain requirements are met, including that (1) the premium paid for the QLAC meets the requirements we discussed earlier, and (2) annuity payments begin no later than the first of the month after the retiree reaches age 85 (at which point the value of the QLAC can no longer be excluded from the RMD calculation).

Contracts for **nonqualified annuities** usually specify an age when annuitization must occur, but this age is much higher than the RMD age for qualified annuities—often age 95 or 100. This longer period of deferral allows a contract owner to amass more cash for retirement, undiminished by current income taxes, until the owner reaches the specified age.

Example: Anita's annuity contract specifies a distribution age of 95. Until then, she can continue to accumulate money in her FRDA on a tax-deferred basis.

- Both annuities held in retirement plans and nonqualified annuities offer the option of guaranteed lifetime income.
- Unlike annuities held in retirement plans, nonqualified annuities are not subject to annual IRS limits on contributions.
- Annuities held in retirement plans are usually funded with pre-tax dollars, whereas nonqualified annuities are funded with after-tax dollars.

- Contributions to nonqualified annuities aren't subject to annual IRS limits—so contract owners can pay as much as the insurer's guidelines allow. Nonqualified annuities are funded with after-tax dollars.

Taxation of Distributions from Qualified and Nonqualified Annuities

Learning Objectives: Explain how annuities held in retirement plans and nonqualified annuities differ in terms of the taxation of their distributions.

Calculate the cost basis of a nonqualified annuity, and explain how to determine the taxable portion of (1) fixed annuity payments, (2) annuity payments for life, and (3) variable annuity payments.

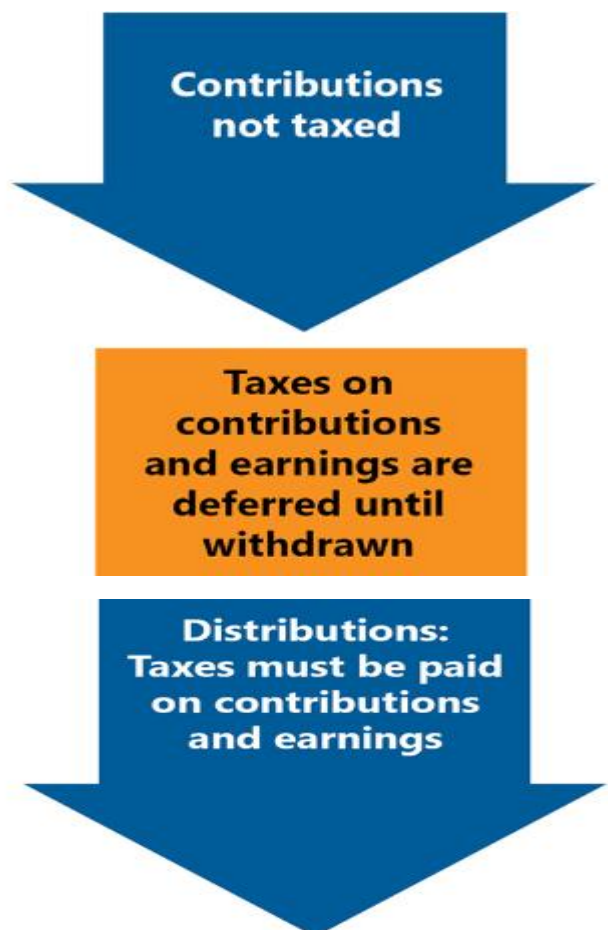
In the lesson on individual retirement arrangements, you learned that distributions from traditional individual retirement annuities are taxed as ordinary income rather than as capital gains.

Que. How do you think distributions from nonqualified annuities and annuities held in retirement plans are taxed?

Ans: Distributions from nonqualified annuities and annuities held in retirement plans are taxed as ordinary income. Let's see how that works.

Taxation of Distributions from Annuities in Plans

Like traditional IRAs, annuities held in retirement plans typically have pre-tax contributions. As a result, the pre-tax contributions—and any earnings on them—must be taxed when they're distributed.



Taxation of Nonqualified Annuity Distributions

With a nonqualified annuity, the money used to fund the annuity has already been taxed, but the investment earnings have not been taxed.

So, for a nonqualified annuity, each annuity payment consists of two parts:

- The **cost basis**, (For a nonqualified annuity, the amount paid for the annuity, which is excluded from the recipient's taxable income when received from the annuity.) or return of principal, which is excluded from the recipient's taxable income.
- The investment earnings, or the gain, which is taxable.



The method used to calculate the amount of each annuity payment to exclude from income depends on whether the annuity payments are fixed or variable.

Taxation of Fixed Annuity Payments

For fixed annuity payments, we use the **exclusion ratio** (A formula used to determine the portion of a fixed annuity payment that is excluded from taxable income.) to determine the portion of an annuity payment to exclude from the recipient's income.

Exclusion ratio = Cost basis ÷ Total expected return

For an annuity with fixed payments, the total expected return is the total amount in annuity payments expected from the annuity.

Total expected return = Amount of annuity payments received each year × Number of years in period

Let's look at an example.

Carolyn Alden owns an annuity that pays her \$1,200 a month for a fixed period of 30 years. She made an initial payment of \$50,000 and two other payments of \$25,000 each. To calculate the annual taxable portion of her annuity income, Carolyn will take these steps.

Taxable portion for fixed annuity payments

Step 1 Add together all the premium payments. This represents the cost basis—the total of her investment in the contract on the date payments begin.

$$\$50,000 + 25,000 + 25,000 = \$100,000$$

Step 2 Calculate the total amount in annuity payments that Carolyn will receive each year.

$$\text{\$1,200} \times 12 \text{ months} = \text{\$14,400 per year}$$

Then calculate the total amount she will receive during the 30-year period—this is the total expected return.

$$\text{\$14,400} \times 30 \text{ years} = \text{\$432,000}$$

Step 3 Divide her cost basis by the total expected return to find the *exclusion ratio*.

$$\text{\$100,000} \div \text{\$432,000} = 23\%$$

Step 4 Multiply the amount in yearly annuity payments by the exclusion ratio. This is the amount Carolyn can exclude from her taxable income each year.

$$\text{\$14,400} \times 23\% = \text{\$3,312}$$

So, she can exclude \$3,312 each year from her taxable income. She'll pay taxes on the difference between her annual annuity payments and the excluded amount.

$$\text{\$14,400} - \text{\$3,312} = \text{\$11,088}$$

So, the taxable portion of her annuity payments will be \$11,088 a year.

Taxation of Lifetime Annuity Payments

In contrast to fixed period and fixed amount payments, a taxpayer who receives lifetime annuity payments can't calculate in advance the exact amount of the total payments the taxpayer will receive.

To calculate the exclusion ratio for lifetime annuity payments, the taxpayer must first determine the total expected return, using the [Internal Revenue Service \(IRS\) Annuity Tables](#) (Internal Revenue Service (IRS) tables that show the life expectancy of annuitants at given ages.). The total expected return is calculated by multiplying the amount of the annuity payments each year by the number of years the IRS Annuity Table indicates the annuitant is expected to live.

Total expected return = Amount of annuity payments received each year × Remaining life expectancy

Let's see how Carolyn Alden from our earlier example would determine the taxable portion of lifetime fixed payments.

Carolyn Alden will receive monthly annuity payments of \$1,200 for life. According to the IRS Annuity Tables, she's expected to live 20 years.

Taxable portion for lifetime fixed annuity payments

Step 1 Calculate the contract's cost basis. $\text{\$50,000} + \text{\$25,000} + \text{\$25,000} = \text{\$100,000}$

Step 2 Calculate the amount in annuity payments she will receive each year.

$$\text{\$1,200} \times 12 \text{ months} = \text{\$14,400 per year}$$

Then calculate the lifetime annuity payments—or the total expected return.

$$\text{\$14,400} \times 20 \text{ years} = \text{\$288,000}$$

Step 3 Divide her cost basis by the total expected return to find the *exclusion ratio*.

$$\text{\$100,000} \div \text{\$288,000} = 35\%$$

Step 4 Multiply the amount in yearly annuity payments by the exclusion ratio. This is the amount Carolyn can **exclude** from her taxable income each year.

$$\text{\$14,400} \times 35\% = \text{\$5,040}$$

Carolyn can exclude \$5,040 each year from her taxable income. The rest is taxable.

$$\text{\$14,400} - \text{\$5,040} = \text{\$9,360}$$

So, the taxable portion of her annuity payments will be \$9,360 a year.

Taxable Income Exception

As a general rule, after a taxpayer receives annuity payments equaling the entire cost basis of the contract, all remaining annuity payments are fully taxable as income.

Variable Annuity Payments

The owner of a variable annuity contract can choose fixed payments, variable payments, or a combination of fixed and variable payments. We calculate the tax liability on fixed payments using the exclusion ratio, just as for payments under fixed annuities.

A taxpayer who receives variable annuity payments uses the following formula to calculate the annual amount she can exclude from her taxable income.

Excluded Amount = Cost Basis ÷ Number of years annuity payments are payable

The number of years that annuity payments are payable for a life annuity option is determined by the life expectancy listed in the IRS Annuity Tables. After the taxpayer receives nontaxable payments equal to the cost basis—the amount invested in the contract—all remaining annuity payments are taxable as income.

Let's consider Carolyn Alden's situation again.

Assume that Carolyn Alden bought a variable annuity and chose lifetime variable annuity payments. According to the IRS Annuity Tables, her life expectancy is 20 years.

Taxable portion for lifetime variable annuity payments

Step 1 Add together all the premium payments. This represents the *cost basis*—the total of her investment in the contract on the date payments begin.

$$\$50,000 + 25,000 + 25,000 = \$100,000$$

Step 2 Divide the total investment by the taxpayer's life expectancy. This amount is excluded from income each year. $\$100,000 \div 20 = \$5,000$

Carolyn can exclude \$5,000 from her taxable income each year. The difference between her annual annuity payments and the excluded amount is taxable. Because she receives variable income payments, the amount she will include as income fluctuates from year to year depending on the performance of her subaccount investments.

Laura Moore bought a nonqualified immediate annuity from the Right Insurance Company.
Which of the following statements about her annuity is true? (Choose all that apply.)

- ☒ Each annuity payment is treated for tax purposes as if it consists of both Laura's cost basis and earnings.
- ☐ Laura's annuity earnings are taxed as capital gains in the year in which she receives them.
- ☒ The exact amount of the total payments Laura will receive from a fixed period or fixed amount annuity is known in advance.

Each annuity payment that Laura receives consist of two parts: her cost basis and her earnings. If Laura's annuity payments are paid as a fixed period annuity or a fixed amount annuity, the exact amount of the total payments she will receive is known in advance. However, Laura's annuity earnings are taxed as **ordinary income** in the year in which she receives them.

Que. To calculate the exclusion ratio for fixed lifetime annuity payments, the taxpayer must determine the total expected return by dividing the amount of the annual annuity payments by the number of years the IRS Annuity Table indicates that the annuitant is expected to live.

Ans: To calculate the exclusion ratio for lifetime annuity payments, the taxpayer must first determine the total expected return, using the Internal Revenue Service (IRS) Annuity Tables. The taxpayer calculates the total expected

return by multiplying the amount of the annual annuity payments by the number of years the IRS Annuity Table indicates the annuitant is expected to live.

Nonqualified Annuities: Surrenders, Exchanges, and Withdrawals

Learning Objectives: Describe how a surrender or exchange of a nonqualified annuity is treated for federal tax purposes. Describe situations in which taxpayers must use the earnings first rule and the cost recovery rule to calculate their taxable income, and explain how these rules affect the amount of a person's taxable income when the person withdraws funds from a nonqualified annuity.

Explain the aggregation rule and identify situations in which the rule applies to nonqualified annuities.

Que. The contract owner of a nonqualified annuity may decide to surrender the annuity and receive its surrender value. Do you think the contract owner would have to pay taxes on the amount of the surrender value?

Ans: Whether the contract owner would owe taxes depends on two values—the owner's cost basis and the annuity's surrender value. Let's take a look.

Surrenders

The owner of a nonqualified deferred annuity can surrender the contract during the accumulation period and receive the annuity's surrender value. If the surrender value is greater than the contract's cost basis, the owner must pay taxes on the excess amount.

Surrender value > Cost basis = Taxes

How does that work?

Example: Simon Kirkland paid a total of \$55,000 for a deferred annuity contract. When he surrendered the annuity several years later, he received \$60,000. Simon must pay taxes in this situation, because:

Surrender value of \$60,000 > Cost basis of \$55,000

The \$5,000 difference between the contract's surrender value (\$60,000) and its cost basis (\$55,000) is taxable as income.

What happens if the contract owner uses the surrender value to purchase another insurance or annuity product?

1035 Exchanges

When a contract owner uses the surrender value to purchase another annuity product, the transaction is considered to be an exchange. Section 1035 of the Internal Revenue Code allows tax-free exchanges of certain insurance and annuity contracts as long as they meet specified requirements.

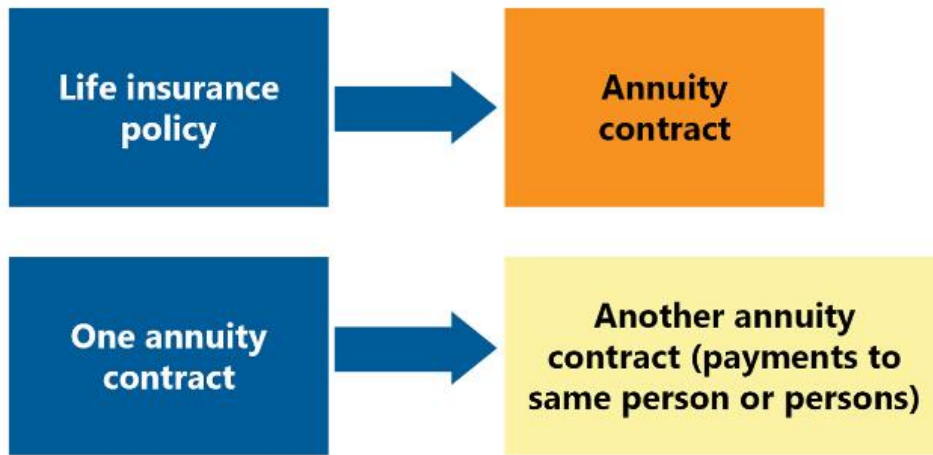
A [Section 1035 exchange](#) includes the exchange of

- A life insurance policy for an annuity contract
- One annuity for another annuity where annuity payments are payable to the same person or persons
- A life insurance policy for another life insurance policy where both policies insure the same person or persons

Because we're focusing on annuities, we illustrate the first two bullets above.

Section 1035 exchange: In the United States, a tax-free replacement of one life insurance policy or annuity contract for another policy or contract covering the same person that is performed in accordance with the conditions of Section 1035 of the Internal Revenue Code.

Acceptable Section 1035 Exchanges



An exchange of an annuity contract for a life insurance policy does **not** qualify as a Section 1035 exchange. Instead, the exchange is treated as if the annuity was surrendered for its surrender value, and any gain realized as a result of the surrender is taxable income.

Unacceptable Section 1035 Exchange



Withdrawals

During the accumulation period of a deferred annuity, the contract owner has the right to take a cash withdrawal from the contract's accumulated value.

Withdrawals are taxable only to the extent that they consist of earnings. Withdrawals of the contract owner's cost basis, which has already been taxed, are not taxable.

The Earnings First Rule

People who paid into an annuity **after** August 13, 1982, are taxed on withdrawals according to the [earnings first rule](#). Under the earnings first rule, any amount that the contract owner withdraws from the contract is treated as a withdrawal of earnings, which is taxable income, until all of the earnings in the contract have been withdrawn.

earnings first rule: A U.S. federal tax rule stating that withdrawals from a nonqualified deferred annuity are considered a withdrawal of earnings, which is taxable income, until the owner has withdrawn all of the earnings in the contract. Thereafter, withdrawals are treated as a nontaxable return of the contract owner's cost basis. Also called the interest first rule or last-in-first-out (LIFO) rule.

After that, all withdrawals are treated as a return of the annuity's cost basis.

Example: In 2012, Andie Byrd bought an individual deferred annuity contract with a single premium payment of \$100,000. **Premium of \$100,000 = Cost Basis**

In 2020, Andie's contract had an accumulated value of \$150,000, which included \$50,000 in earnings.

\$100,000 Cost Basis + \$50,000 Earnings = \$150,000 Total Value

In 2020, Andie withdrew \$30,000 from the contract.

\$150,000 Total Value - \$30,000 Withdrawal = \$120,000 Total Value

Because the amount of Andie's withdrawal (\$30,000) was less than the total earnings in the contract (\$50,000), the entire \$30,000 is taxable.

\$50,000 Earnings - \$30,000 Withdrawal = \$20,000 Earnings

The Cost Recovery Rule

People who made purchase payments for an annuity **before** August 14, 1982, are taxed on withdrawals according to the [cost recovery rule](#). Under the cost recovery rule, amounts withdrawn from an annuity are considered a return of the owner's cost basis first, and are therefore nontaxable, until the entire cost basis has been withdrawn.

All subsequent withdrawals are considered earnings and are taxed as income.

cost recovery rule: A U.S. federal tax rule stating that withdrawals from a nonqualified deferred annuity are considered a return of the owner's cost basis first, and are therefore nontaxable, until the entire cost basis has been withdrawn. All subsequent withdrawals are considered earnings and are taxed as income. Also called the first-in-first-out (FIFO) rule.

Example: Janine Worthington bought a deferred annuity with a single premium payment of \$75,000 in 1981. In 2021, she withdrew \$80,000 from the contract. At that time, her annuity's accumulated value was \$200,000. Because Ms. Worthington's withdrawal of \$80,000 is more than the cost basis of her contract—\$75,000—only \$75,000 of the withdrawal is nontaxable. The rest is a withdrawal of earnings and is taxable as income. **\$80,000**
- \$75,000 = \$5,000 taxable earnings

Before and After

For an annuity contract issued before August 14, 1982, but the contract owner made purchase payments before and after that date, determining taxable income is more complicated. In effect, we must divide the annuity into two parts—pre- and post-August 14, 1982—with each part consisting of purchase payments and earnings.

When the owner withdraws funds, the insurer allocates withdrawal amounts first to recovery of purchase payments made before August 14, 1982, and then to earnings on those payments (the cost recovery rule).

When the entire accumulated value of this part of the contract has been exhausted, the insurer allocates withdrawals to earnings and then purchase payments made after August 13, 1982 (the earnings first rule).

Aggregation Rule

Taxes on withdrawals from nonqualified annuities are also subject to the [aggregation rule](#), which states that all deferred annuity contracts issued...

aggregation rule: A U.S. federal tax rule which states that, for purposes of determining the amount of any withdrawal from a nonqualified deferred annuity that is taxable as income, all nonqualified deferred annuity contracts issued (1) after October 21, 1988, (2) by the same insurer to the same contract owner, and (3) during the same calendar year will be treated as one contract.

- After October 21, 1988
- By the same insurer to the same contract owner
- During the same calendar year

...are treated as one contract for purposes of determining the amount of any withdrawal that is taxable as income.

Que. An exchange of an annuity contract for a life insurance policy qualifies as a Section 1035 exchange

Ans: An exchange of an annuity contract for a life insurance policy **does not** qualify as a Section 1035 exchange.

Instead, the exchange is treated as if the annuity was surrendered for its surrender value, and any gain realized as a result of the surrender is taxable income.

Don Dillon wants to surrender the nonqualified annuity that he purchased from Falcon Life Insurance. Which of the following statements about his annuity are true? (Choose all that apply.)



If the surrender value of Don's annuity is greater than the contract's cost basis, he must pay taxes on the excess amount.



If Don uses the surrender value of the contract to purchase another annuity product where annuity payments are made to the same person or persons, this transaction is considered an exchange.

Que. Barry Seaver purchased a nonqualified deferred annuity in 2010. Any withdrawals that he makes from his annuity will be taxed according to the cost recovery rule. (True/False)

Ans: Individuals who paid into a nonqualified annuity after August 13, 1982, are taxed on withdrawals according to the earnings first rule. Under the earnings first rule, any amount that Barry withdraws from the contract is treated as a withdrawal of earnings, which is taxable income, until all of the earnings in the contract have been withdrawn.

Que. Maureen McKinnon bought a nonqualified annuity before August 14, 1982, but made purchase payments before and after that date. When Maureen withdraws money from her annuity, the amount of taxable income will be determined using

Ans: Maureen's withdrawal amounts are allocated first to recovery of purchase payments made before August 14, 1982, and then to earnings on those payments (the cost recovery rule). When the entire accumulated value of this part of the contract has been exhausted, Maureen's withdrawals are allocated to earnings and then purchase payments made after August 13, 1982 (the earnings first rule).

Penalty Taxes and Exceptions

Learning Objective: Describe the penalty taxes imposed on premature distributions from qualified and nonqualified annuities, and identify common situations in which these distributions are exempt from these tax penalties.

Que. Recall that owners of individual retirement arrangements—including individual retirement annuities—may be subject to penalty taxes if they take a distribution before age 59½. Do you think this rule also applies to nonqualified annuities and annuities held in retirement plans?

Ans: The 10% penalty tax on premature distributions also applies to nonqualified annuities and annuities held in retirement plans.

Penalty Taxes

Whether they're qualified or nonqualified, annuities are designed for the same purpose—retirement savings. Because of this, the IRS established the 10% penalty tax to discourage owners from taking premature distributions from their annuities.

Recall that the penalty tax applies only to the amount of any withdrawal that is taxable.

Penalty Tax Exceptions

Some premature distributions are exempt from this penalty. Determining whether a distribution is exempt sometimes depends on whether the annuity is nonqualified or qualified—and, for a qualified annuity, whether it's an IRA or an annuity held in a retirement plan.

Recall that we covered the IRA exceptions in the lesson on individual retirement arrangements, so we will not repeat them here.

(Click or touch the arrows below to learn about all the exceptions.)

First we'll look at the tax exceptions that apply to **ALL** types of annuities. Typically, the IRS does not apply a penalty tax on a distribution taken before age 59½ in the following situations:

- **Death**—Distributions taken on or after the death of the contract owner or plan participant.
- **Disability**—Distributions taken as a result of the contract owner's or participant's becoming disabled.
- **Substantially Equal Periodic Payments (SEPPs)**—Distributions taken as a series of substantially equal periodic payments, which are based on the contract owner's or participant's life expectancy (or the joint lives of the contract owner or participant and beneficiary) and are paid without interruption for at least five years or until the owner or participant reaches age 59½, whichever is later. (Note that SEPPs can be used for qualified retirement plan distributions only after the individual has separated from service.)

An additional exception applies to distributions from an **annuity held in a retirement plan** in the following situation:

- **Medical expenses**—Distributions taken to pay unreimbursed medical expenses that are more than a specified percentage of the contract owner's or participant's adjusted gross income

Finally, the following exceptions apply *only* to distributions from **nonqualified annuities**:

- **Immediate annuity**—Distributions taken from an immediate annuity contract
- **Pre-August 14, 1982**—Distributions taken from amounts invested before August 14, 1982, and earnings on those investments
- **Structured settlements**—Distributions taken from an annuity purchased as part of a structured settlement agreement, which makes annuity payments due to a personal injury or workers' compensation claim

The following table summarizes all of these exceptions to the penalty tax for premature distributions.

Exceptions to the 10% Penalty Tax for Premature Distributions

Distributions taken...	Applies to Nonqualified Annuities	Applies to Annuities in Retirement Plans
...on or after the death of the contract owner or plan participant	✓	✓
...as a result of the contract owner's or participant's disability	✓	✓
...as a series of substantially equal periodic payments, or SEPPs	✓	✓
...to pay unreimbursed medical expenses that are more than a specified percentage of the contract owner's or participant's adjusted gross income		✓
...from an immediate annuity contract	✓	
... from amounts invested before August 14, 1982 , and earnings on those investments	✓	
... from an annuity purchased as part of a structured settlement agreement , which makes annuity payments due to a personal injury or workers' compensation claim	✓	

The following table summarizes all the differences between qualified and nonqualified annuities that we've discussed in this lesson.

Summary of Differences Between Annuities Held in Plans and Nonqualified Annuities

	Annuities in Retirement Plans (Qualified)	Nonqualified Annuities
Earnings during accumulation period	Tax deferred	Tax deferred
Annual IRS contribution limits	Yes	No, but insurers typically limit premiums to \$1 million
Taxation of contributions	Contributions usually made with pre-tax funds	Contributions made with after-tax funds
Distribution requirements	Generally must begin by April 1 of year following year in which owner turns age 72 and continue each year after that	Must begin at an age specified in the contract, such as 95 or 100
Taxation of distributions	Entire amount generally taxed as ordinary income	Formulas determine portion of distribution that is taxed
10% penalty tax for premature distributions not covered by an exception?	Yes	Yes

Que. For ALL types of annuities, the IRS does not apply a penalty tax on a distribution taken before age 59½ in which of the following situations?

Ans: The three exceptions that apply to distributions from all types of annuities are death, disability, and choosing to receive substantially equal periodic payments (SEPPs)

Que. Karla Kinney, who's 50, wants to begin taking distributions from her nonqualified annuity as substantially equal periodic payments, or SEPPs. How long do you think she'll have to take distributions to avoid paying a penalty tax?

Ans: Distributions taken as a series of substantially equal periodic payments, which are based on the contract owner's life expectancy and are paid without interruption for at least five years or until the owner reaches age 59½, whichever is later, are not subject to a penalty tax. Karla will have to continue her distributions until she is at least 59½.

Conclusion

People purchase annuities to accumulate assets for retirement and to receive a guaranteed source of income during retirement. Due to the decline in pension plans, securing a source of guaranteed income to supplement Social Security benefit payments is becoming more appealing to more people. However, annuities can be difficult to understand, and they aren't suitable for everyone.

In this module, we attempted to demystify annuities. We described the major types of annuities and their features—including various ways to accumulate assets, withdraw funds during the accumulation period, and receive annuity payouts. We also looked at the tax aspects of qualified and nonqualified annuities. As an insurance product, annuities offer guarantees not found in other products, but those guarantees do have costs. As more and more people pack their retirement suitcases, understanding annuity benefits and costs is more important than ever.

