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Annuities

This chapter includes a discussion about annuities. It is important for you to understand what annuities are and how they differ from life insurance. By the end of this chapter, you will be able to describe the different roles of the owner, annuitant, and beneficiary, discuss different classification of annuities such as immediate vs. deferred and fixed vs. variable, and identify proper uses of different types of annuities.

TERMS TO KNOW

Deferred — withheld or postponed until a specified time or event in the future
IRS — Internal Revenue Service: a U.S. Government agency responsible for collecting of taxes, and enforcement of the Internal Revenue Code
Life contingency — dependent upon whether or not the insured is alive
Liquidation of an estate — converting a person's net worth into a cash flow
Natural person — a human being
Qualified plan — a retirement plan that meets the IRS guidelines for receiving favorable tax treatment
Suitability — a requirement to determine if an insurance product or an investment is appropriate for a particular customer

A. The Annuity Principles

An **annuity** is a contract that provides income for a specified period of years, or for life. An annuity protects individuals against outliving their money. Annuities are not life insurance, but rather a vehicle for the accumulation of money and the **liquidation of an estate**. Annuities are marketed by life insurance companies. Licensed life insurance agents are authorized to sell some types of annuities.

Annuities do not pay a face amount upon the death of the annuitant. In fact, they do just the opposite. In most cases, the payments stop upon the death of the annuitant. Annuities use *mortality tables*, but these tables reflect a longer life expectancy than the mortality tables used for life insurance. *Mortality tables* indicate the number of individuals within a specified group (e.g., males, females, smokers, nonsmokers) starting at a certain age, who are expected to be alive at a succeeding age.

1. The Parties

Owner – The purchaser of the annuity contract, but not necessarily the one who receives the benefits. **The owner of the annuity has all of the rights,** such as naming the beneficiary and surrendering the annuity. The owner of an annuity may be a corporation, trust, or other legal entity.

Annuitant – The person who receives benefits or payments from the annuity, whose life expectancy is taken into consideration, and for whom the annuity is written. The annuitant and the contract owner do not need to be the same person, but most often are. A corporation, trust or other legal entity may own an annuity, but the **annuitant must be a natural person**.

Know This! Because annuities are based on the life expectancy of an annuitant, the annuitant must be a natural person, regardless of who owns the policy.

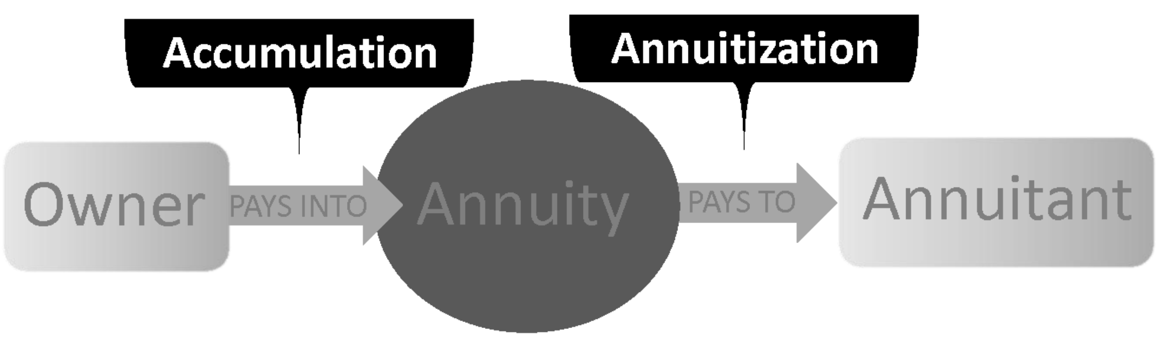
Beneficiary – The person who receives annuity assets (either the amount paid into the annuity or the cash value, whichever is greater) if the annuitant dies during the accumulation period, or to whom the balance of annuity benefits is paid out.

2. Accumulation Period vs. Annuity Period

The **accumulation period**, also known as the **pay-in period**, is the period of time over which the owner makes payments (premiums) into an annuity. Furthermore, it is the period of time during which the payments earn interest on a tax-deferred basis.

The **annuity period**, also known as the **annuitization period**, **liquidation period**, or **pay-out period,** is the time during which the sum that has been accumulated during the accumulation period is converted into a stream of income payments to the annuitant. The annuity period may last for the lifetime of the annuitant or for a specified period, which could be longer or shorter. The *annuitization date* is the time when the annuity benefit payouts begin (trigger for benefits).

Know This! During the accumulation period, funds are paid INTO the annuity. During the annuity period, funds are paid OUT to the annuitant.



The annuity income amount is based upon the following:

- The amount of premium paid or cash value accumulated;
- The frequency of the payment;
- The interest rate; and

- The annuitant's age and gender.

An annuitant whose life expectancy is longer will have smaller income installments. *For example,* all other factors being equal, a 65-year-old male will have higher annuity income payments than a 45-year-old male (because he is younger), or than a 65-year-old female (because women statistically have a longer life expectancy).

Know This! Shorter life expectancy = higher benefit; longer life expectancy = lower benefit.

If an annuitant dies during the accumulation period, the insurer is obligated to return to the beneficiary either **the cash value** or **the total premiums paid**, whichever is greater. If a beneficiary is not named, the death benefit will be paid to the annuitant's estate.

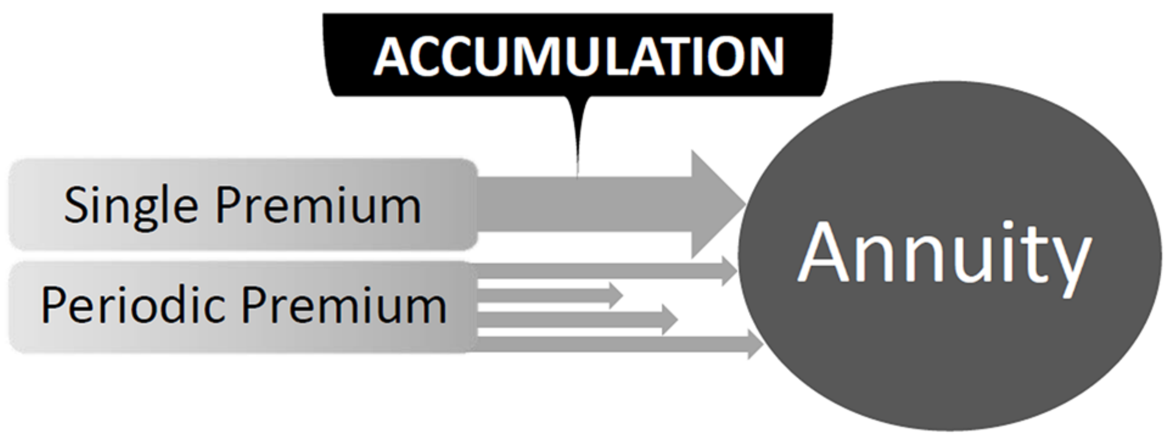
B. Types Of Annuities

Annuities can be classified according to how premiums are paid into the annuity, how premiums are invested, and when and how benefits are paid out.

Know This! Classification of annuities:

- Premium payment method: single premium vs. periodic
- When income payments begin: immediate vs. deferred
- How premiums are invested: fixed vs. variable
- Disposing of proceeds: pure life, annuity certain, or life refund annuity

1. Premium Payment Options



The first way to classify annuities can be based on how they can be funded (paid for). There are 2 options: a **single premium** (one-time lump-sum payment) or through **periodic payments** in which the premiums are paid in installments over a period of time. Periodic payment annuities can be either **level premium**, in which the annuitant/owner pays a fixed installment, or **flexible premium**, in which the amount and frequency of each installment varies.

2. When Benefits Begin - Immediate vs. Deferred Annuities

Annuities can also be classified according to when the income payments from the annuity begin. An **immediate annuity** is one that is purchased with a single, lump-sum payment and provides income payments that start **within one year** from the date of purchase. Typically, an immediate annuity will make the first payment as early as 1 month from the purchase date. Most commonly, this type of annuity is known as a Single Premium Immediate Annuity (SPIA).

A **deferred annuity** is an annuity in which the income payments begin sometime **after one year** from the date of purchase. Deferred annuities can be funded with either a single lump sum (Single Premium Deferred Annuities — SPDAs) or through periodic payments (Flexible Premium Deferred Annuities — FPDAs). Periodic payments can vary from year to year. The longer the annuity is deferred, the more flexibility for payment of premiums it allows.

Know This! An immediate annuity is purchased with a *single premium*.

Know This! Income payments from a deferred annuity begin sometime *after 1 year* from the date of purchase.

Nonforfeiture

The nonforfeiture law stipulates that a deferred annuity must have a guaranteed surrender value that is available if the owner decides to surrender the annuity prior to annuitization (e.g., 100% of the premium paid, less any prior withdrawals and related surrender charges). However, a 10% penalty will be applied for early withdrawals (prior to age 59 ½).

Surrender Charges

The purpose of the surrender charge is to help compensate the company for loss of the investment value due to an early surrender of a deferred annuity.

A surrender charge is levied against the cash value, and is generally a percentage that reduces over time. A common surrender charge might be 7% the first year, 6% the second year, and 5%, 4%, 3%, 2%, 1%, and 0% respectively thereafter. Therefore, if the annuity is surrendered in the 8th year or after there would be no further surrender charge. **At surrender, the owner gets the premium, plus interest (the value of the annuity), minus the surrender charge.**

Example:

Assume that the annuity owner paid $700 in premium, which accumulated a total of $35 of interest, and a surrender charge is $70. If the annuity is surrendered prematurely, what will the annuity value be at surrender? The answer is $665.

($700 Premium + $35 Interest) - $70 Surrender Charge = $665 Value of the Annuity

3. Annuity Investment Options

Annuities may be classified as fixed or variable based on how the premium payments are invested.

Fixed Annuities

A **fixed annuity** provides the following features:

- Guaranteed minimum rate of interest to be credited to the purchase payment(s);
- Income (annuity) payments that do not vary from one payment to the next; and
- The insurance company guarantees the specified dollar amount for each payment and the length of the period of payments as determined by the settlement option chosen by the annuitant.

With fixed annuities, the annuitant knows the exact amount of each payment received from the annuity during the annuity period. This is called **level benefit payment amount**. A disadvantage to fixed annuities is that the purchasing power that they afford may be eroded over time due to inflation.

General Account Assets

Fixed annuity premiums are deposited into the life insurance company's **general account.** The general account is comprised mostly of conservative investments like bonds. These investments are secure enough to allow the insurance company to guarantee a specified rate of interest, as well as assure the future income payments that the annuity will provide.

Know This! In fixed annuities, the premiums are deposited in the company's *general account*.

Interest Rate Guarantees (Minimum vs. Current)

In fixed annuities, the **insurer bears the investment risk**. Future interest rates actually paid by an insurer are based upon the performance of the insurance company's general account. However, the rate may not drop below a policy's **guaranteed minimum** (typically 3%). Should interest rates drop below this guaranteed rate, the insurer is obligated to pay the guaranteed rate amount.

During the accumulation phase, the insurer will invest the principal, or accumulation, and give the annuitant a guaranteed interest rate based on a minimum rate as specified in the annuity, or the **current interest rate**, whichever is higher. The minimum rate is the lowest rate that the principal can contractually earn.

Equity Indexed Annuities

Indexed (or equity indexed) annuities are fixed annuities that invest on a relatively aggressive basis to aim for higher returns. Like a fixed annuity, the indexed annuity has a *guaranteed minimum* interest rate (typically, 3 or 4%), which provides a guarantee for a certain rate of growth. At the end of the contract term, the annuity will be credited with the greater of the **guaranteed minimum** value or the **current (indexed)** value. The *current interest* rate that is actually credited is often tied to a familiar index like the Standard and Poor's 500.

Generally, the insurance companies reserve the initial returns for themselves but pay the excess to the annuitant. *For example*, the company may keep the first 4% earned for itself, but any accumulation in excess of 4% is credited to the annuitant's account. So if the interest earned is 12%, the company keeps 4% and credits the client’s account with 8%.

Equity indexed annuities are less risky than a variable annuity or mutual fund but are expected to earn a higher interest rate than a fixed annuity.

Variable Annuities

A **variable annuity** serves as a hedge against inflation, and is variable from the standpoint that the annuitant may receive different rates of return on the funds that are paid into the annuity. Listed below are the 3 main characteristics of variable annuities:

- **Underlying Investment:** the payments that the annuitant makes into the variable annuity are invested in the insurer's separate account, not their general account. The separate account is not part of the insurance company's own investment portfolio, and is not subject to the restrictions that are applicable to the insurer's own general account.
- **Interest Rate:** issuing insurance company does not guarantee a minimum interest rate.
- **License Requirements:** a variable annuity is considered a **security** and is regulated by the Securities Exchange Commission (SEC) in addition to state insurance regulations. An agent selling variable annuities must hold a securities license in addition to a life insurance license. Agents or companies that sell variable annuities must also be properly registered with FINRA.

Variable premiums purchase **accumulation units** in the fund, which is similar to buying shares in a Mutual Fund. Accumulation units represent ownership interest in the separate account. Upon annuitization, the accumulation units are converted to **annuity units**. The income is then paid to the annuitant based on the value of the annuity units. The number of annuity units received remains level, but the unit values will fluctuate until actually paid out to the annuitant.

FEATURES	FIXED ANNUITY	VARIABLE ANNUITY
Interest Rate	Guaranteed by insurer	No guarantee
Underlying Investment	General account (safe, conservative)	Separate account (equities, no guarantee)
License Needed	Life insurance	Life insurance PLUS securities
Expenses	Guaranteed	Guaranteed

Income Payment	Guaranteed	No guarantee

4. Life Contingency Options - Pure Life vs. Life with Guaranteed Minimum

The life annuity will pay a specific amount for the remainder of the annuitant's life. With **pure life**, also known as **life-only** or **straight life**, this payment ceases at the annuitant's death (no matter how soon in the annuitization period that occurs). This option **provides the highest monthly benefits** for an individual annuitant. Under this option, while the annuity payments are guaranteed for the lifetime of the annuitant, there is no guarantee that all the proceeds will be fully paid out.

Under the **life with guaranteed minimum** settlement option, if the annuitant dies before the principal amount has been paid out, the remainder of the principal amount will be refunded to the beneficiary. This option is also called **refund life**. It guarantees that the entire principal amount will be paid out.

Know This! Pure life annuity provides the highest monthly benefit, but there is no guarantee that the entire principal will be paid out.

There are two types of refund life annuities:

- **Cash refund** — when the annuitant dies, the beneficiary receives a lump-sum refund of the principal minus benefit payments already made to the annuitant. Cash refund option does not guarantee to pay any interest.
- **Installment refund** — when the annuitant dies, the beneficiary will continue to receive guaranteed installments until the entire principal amount has been paid out.

Note, however, that any unpaid annuity benefits following the death of an annuitant are taxable when paid to the beneficiary.

Life with period (term) certain is another life contingency payout option. Under this option, the annuity payments are guaranteed for the *lifetime of the annuitant*, and for a *specified period of time* for the beneficiary. *For example,* a life income with a 20-year period certain option would provide the annuitant with an income while the annuitant is living (for the entire life). If, however, the annuitant dies shortly after payments begin, the payments will be continued to a beneficiary for the remainder of the 20-year period.

Single Life vs. Multiple Life

Single life annuities cover **one life**, and annuity payments are made with reference to one life only. Contributions can be made with a single premium or on a periodic premium basis with subsequent values accumulating until the contract is annuitized.

Multiple life annuities cover **2 or more lives**. The most common multiple life annuities are joint life, and joint and survivor.

Joint Life

Joint life is a payout arrangement where two or more annuitants receive payments until the first death among the annuitants, and then payments stop.

Joint and Survivor

The **joint and survivor** arrangement is a modification of the life income option in that it guarantees an income for two recipients that neither can outlive. Although it is possible for the surviving recipient(s) to receive payments in the same amount as the first recipient to die, most contracts provide that the surviving recipients will receive a reduced payment after the first recipient dies. Most commonly, this option is written as “joint and ½ survivor” or "joint and 2/3 survivor,” in which the surviving beneficiary receives ½ or 2/3 of what was received when both beneficiaries were alive. This option is commonly selected by a couple in retirement. As with the life income option, there is no guarantee that all the proceeds will be paid out if both beneficiaries die shortly after the installments begin.

5. Guarantee of Minimum Total Benefit

Annuity payment options specify how annuity funds are to be paid out. They are very similar to the settlement options used in life insurance that determine how the policy proceeds are distributed to the beneficiaries.

Annuity with Period Certain

In contrast with life contingency benefit payment options, annuities certain are **short-term annuities** that limit the amounts paid to a certain fixed period or until a certain fixed amount is liquidated.

Fixed Period

With **fixed-period installments**, the annuitant selects the time period for the benefits, and the insurer determines how much each payment will be, based on the value of the account and future earnings projections. This option pays for a specified amount of time only, whether or not the annuitant is living.

Know This! The fixed-period option pays for a specific time only, whether or not the annuitant is living.

Fixed Amount

With **fixed-amount installments**, the annuitant selects how much each payment will be, and the insurer determines how long the benefits will be paid by analyzing the value of the account and future earnings. This option pays a specific amount until funds are exhausted, whether or not the annuitant is living.

C. Personal Uses Of Annuities

The principal use of an annuity is to provide income for **retirement**; however, an annuity may be used for any accumulation of cash or simply to liquidate an estate. Because of the various uses of annuities, agents should always assess how well a recommended product will meet the applicant's needs and resources — the **suitability** of a product.

Know This! The main use of annuities is to provide retirement income.

It is a producer's responsibility to make sure that annuity transactions address consumers' needs and financial objectives. To ensure suitability, producers must make a reasonable effort to obtain relevant information from the consumer and evaluate the following factors:

- Age;
- Annual income;
- Tax status;
- Financial needs and timeline;
- Investment objectives;
- Liquidity needs and liquid net worth;
- Existing assets;
- Intended use of annuity;
- Financial experience; and
- Risk tolerance.

1. Lump-sum Settlements

Annuities may serve as an ideal financial vehicle for someone who comes into a large lump sum of money, such as inheritance, lottery, award of damages from a lawsuit, proceeds from a sale of a business, or a lump-sum distribution from a qualified pension plan. In this case, a person may purchase a **single premium immediate annuity**, which will convert the lump sum into a series of periodic payments, providing a stream of income for the annuitant.

2. Retirement Income

Since annuities are a popular means to provide retirement income, they are often used to fund **qualified retirement plans**, which means they meet the IRS guidelines to receive favorable tax treatment.

Qualified retirement annuities can be **individual** (such as individual retirement accounts — IRAs), and **group** (such as tax-sheltered annuity — TSA, or profit-sharing pension plans).

Guaranteed Minimum Withdrawal Benefit

Retirement annuities may offer a **Guaranteed Minimum Withdrawal Benefit** (GMWB) option to the annuitant. With this option, the annuitant can withdraw a maximum percentage of his or her investment annually until the initial investment has been recovered. This option protects the annuitant against investment losses.

3. Education Funds

In addition to providing income for retirement and estate liquidation, annuities can be used to accumulate funds for college education. An annuity can provide savings on a tax-deferred basis for the education expenses of the annuitant.

D. Annuities Summary Chart

ANNUITIES

Phases

Accumulation period - payments in, to insurer

Annuitization period - payments out, to insured

Parties

Annuitant - insured; policy issued on annuitant's life; must be a natural person

Beneficiary - will receive any amount contributed to annuity (plus any gain) if annuitant dies during accumulation period

Owner - has all rights to policy (usually annuitant); can be corporation or trust

Types of Annuities

Fixed Annuities - guaranteed, fixed payment amount; premiums in general account

Equity Indexed Annuities - interest rate tied to an index. Earn higher rate than fixed annuities, not as risky as variable annuities or mutual funds.

Variable Annuities - payment not guaranteed. Premiums are in separate account, and invested in stocks and bonds.

Premium Payments

Single - ONE lump-sum payment; the principal is created immediately (used for both immediate and deferred annuities).

Periodic (Flexible) - multiple payments; the principal is created over time (used for deferred annuity only).

Income Payments

Immediate - purchased with a single premium; income payments start within one year from the date of purchase

Deferred - purchased with either lump-sum or periodic payments premium. Benefits start sometime after one year from the date of purchase (often used to accumulate funds for retirement).

Settlement Options

Life Only - insured cannot outlive income. Any monies not paid out are retained by company at insured's death. Pays highest monthly amount.

Refund Life Annuity - Guaranteed lifetime income. If annuitant dies, balance is "refunded" to beneficiary. Installment option gives beneficiary payments until purchase amount is paid out. Cash refund gives refund of balance of original annuity purchase amount minus payments made to annuitant.

Life with Period Certain - specific monthly payment for life and a specific period of time. If annuitant dies before payment period is up, payment goes to beneficiary.

Joint Life - 2 or more annuitants receive payments until first death, then payments cease.

Joint and Survivor - Income for 2 or more that cannot be outlived. Often used with period certain. When one annuitant dies, the other receives either 1/2 or 2/3 of the original payment amount.

Lump-sum - paid at annuitization; all interest accumulated is taxable. Additional 10% penalty imposed prior to annuitant's reaching 59 1/2.

Annuities Certain - payment guaranteed for fixed period or until certain fixed amount paid. NO LIFE option.

Interest Rate

Guaranteed - company must pay this minimum percentage. Typically around 3%.

Current - exceeds guaranteed rate. Paid to annuitant when a company's own investment is better than expected.

E. Educational Highlights

Take another look at the topics discussed in this chapter. Try to answer the following questions on your own and then verify the correct answers:

1. *Who receives benefits or payments from an annuity?*
   The annuitant receives benefits or payments from an annuity during the annuitization period.
2. *If the annuitant dies during the accumulation period, what happens to the account?*
   If the annuitant dies before annuitization (or payout period), his/her beneficiary will receive the amount paid into the plan or the cash value, whichever is greater.
3. *An annuity can have 2 distinct periods. What are they called, and what happens during each?*
   The accumulation period, also known as the pay-in period, is the period of time over which the annuitant makes payments (premiums) into an annuity. The annuity period, also referred to as the annuitization period, liquidation period, or pay-out period, is the time when money is distributed to the annuitant.
4. *How does inflation affect the purchasing power of a fixed annuity?*
   Inflation can erode the purchasing power of income payments.
5. *What are accumulation units?*
   Accumulation units represent ownership interest in the separate account. Instead of buying "shares," the annuity holder purchases units.
6. *What type of annuity credits its interest based upon an index like the S&P 500?*
   Equity Indexed Annuities, which they invest on a relatively aggressive basis to aim for higher returns.
7. *How long will a life annuity with 15-year certain pay with a Joint and Survivor option?*
   The annuity will pay out for a guaranteed 15 years. After that, it will pay out for as long as the annuitants are living.
8. *How long will a life annuity with 15-year certain pay?*
   A life annuity with 15-year certain will pay for the life of the annuitant; however, if the annuitant dies shortly after the annuity payments begin, the payment to the beneficiary will only last 15 years.