TEXAS 2011 ANNUITY INITIAL TRAINING

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Texas 2011 Annuity Initial Training

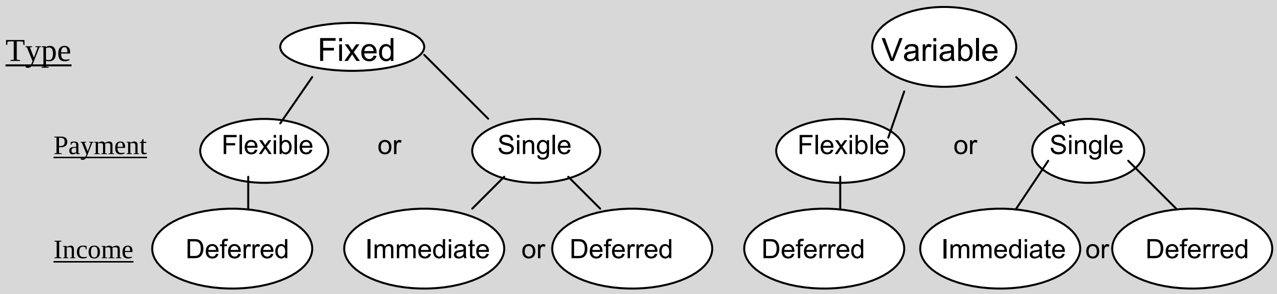
I Types of Annuities and Various Classifications of Annuities

A. Annuities Defined

An annuity is defined as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and to continue throughout a specified period of time or for the duration of a designated life or lives.

Annuity contracts in the United States are defined by the Internal Revenue Code (IRC) and regulated by the individual states. Variable annuities have features of both life insurance and investment products. In the U.S., annuity contracts may be issued only by life insurance companies, although private annuity contracts may be arranged between donors to non-profits to reduce taxes. Insurance companies are regulated by the states, so contracts or options that may be available in some states may not be available in others. Their federal tax treatment, however, is governed by the IRC. Variable annuities are regulated by the Securities and Exchange Commission and the sale of variable annuities is overseen by FINRA. There are two phases for an annuity, the first phase is when the annuity contract owner deposits and accumulates money into an account (the deferral phase), and another phase in which customers receive payments for some period of time (the annuity or income phase).

<u>Chart III A</u>



B. Annuity type, when benefits are paid

1. Immediate Annuity

If a person pays for an annuity and the benefits begin after a relatively short delay, this is described as an immediate annuity. An immediate annuity contract is a single premium contract providing substantially equal annuity payments that start within one year from the date of purchase and are paid at least annually. In the case of the single-premium immediate annuity, there is no accumulation phase

2. Deferred Annuity

If a person pays for an annuity and benefits do not begin at once, this is a deferred annuity. A single-premium deferred annuity, for example, includes a waiting period between the premium payment and the beginning of annuity payouts. The promised stream of payments for a given premium is greater for a single-premium deferred annuity than for a single-premium immediate annuity, since the premium is invested and earns returns between the date when it is paid and the date when the payouts begin. A variant on such an annuity, one that provides for multiple premium payments, could represent a saving plan for an individual who plans to use an annuity to draw down accumulated resources. The income on assets held in a deferred annuity account is not taxed until the payout phase, which can be many years after the income accrues. Annuities therefore afford and opportunity for asset accumulation at the pre-tax rate of return.

3. Immediate vs. Deferred Annuity

In an immediate annuity, payments begin to the buyer immediately (with a year) upon purchasing the contract. An immediate annuity is used when an investor needs to have a consistent income stream from a lump sum investment. A deferred annuity delays payments to the buyer until a future time -- at retirement for example. The money invested in the contract grows during this deferred period. (This is called the "accumulation" period.) A deferred annuity is appropriate for someone wanting tax deferred growth on their assets.

When to Buy an Immediate Annuity Immediate annuities provide a guaranteed stream of income payments for the rest of an individual's life or for a specific period of time selected at the time of purchase. Making a one-time contribution purchases an immediate annuity. Payments from the annuity begin within the first year after purchase.

An immediate annuity should be considered by a prospective purchaser if:

- He or she has a lump sum of money and need to start receiving dependable income
- The purchaser needs an immediate return from their investment
- The annuitant wants to receive a steady monthly check for the rest of his or her life

Remember that immediate annuity payments often maintain the same dollar amount throughout the life of the payment terms.

When to Buy a Deferred Annuity- Deferred annuities allow money to accumulate over time and grow tax-deferred several years before the start of payments. Deferred annuities are designed for long-term savings, such as retirement. When someone starts receiving income from their deferred annuity, there are several payment choices available, similar to the options available in an immediate annuity. Deferred annuities may have withdrawal charges that apply if the annuitant decides to take money out in the first few years of the contract. There are usually provisions that allow access to a small percentage funds in case of unforeseen need.

A deferred annuity should be considered by a prospective purchaser if:

- An individual wants to save for retirement and enjoy tax-deferred growth
- He or she already contributes the maximum to a 401(k), TSA, IRA or other retirement plan and still wants to save more for retirement
- The person is self-employed or own a business and needs to set up a retirement plan

Deferred annuities can be part of an employer-sponsored retirement plan or an IRA account, but can also be used as an additional means of saving for retirement or funding other long-term savings goals.

C. Annuity type, how and when premiums are paid

1. Single premium annuity

When only a single deposit is allowed and no future deposits can be made. The original lump sum will begin to grow based on the provisions agreed upon issuance. Money will build inside the annuity on a tax-deferred basis, and cannot be accessed until the annuitant attains age 59 1/2 without penalty. After that point, only earnings are taxed, the original principal is returned on an after-tax basis. Since there was no income tax deduction on the original deposit, it is returned income tax-free. If partial withdrawals are taken from an annuity, a portion of each payment may be considered return of principal, and a portion considered interest. In this case, an "exclusion ratio" as prescribed in the IRS tax codes applies to calculate the taxable portion.

2. Flexible premium annuity

Flexible Premium Annuities are issued by insurance companies who allow varying premium deposits after satisfying an initial minimum premium payment. A person may deposit as little (within company minimums) or as much from that point on as desired. The money will build inside the annuity on a tax-deferred basis, and cannot be accessed until age 59 1/2 without penalty. After that point, only earnings are taxed, the original principal is returned on an after-tax basis. Again this is because there was no income tax deduction on the original deposits. Partial withdrawals from an annuity can cause a portion of each payment to be considered return of principal and a portion considered interest. The exclusion ration applies in this case as well.

3. Single Premium vs. Flexible Premium

A single premium annuity is purchased with a single payment. Flexible premium contracts are purchased with a minimum down payment and subsequent payments to be made at the discretion of the investor. Flexible premiums are usually associated with deferred annuities as they give the investor the chance to add to the contract over numerous years.

D. Annuity type, investment options offered

1. Variable annuity

A variable annuity can be purchased by making either one or a series of payments. A variable annuity offers a range of investment options. The value of the investment will vary depending on the performance of the investment options chosen by the annuitant. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three. Although invested in mutual funds, variable annuities differ from mutual funds in several important ways;

- They provide periodic payments for life or an agreed-to time span (or the life of a spouse or some other designated person).
- A death benefit is offered. If the annuitant dies before the insurer has started making payments, a beneficiary is guaranteed to receive a specified amount – typically at least the principal amount.
- Variable annuities are tax-deferred. No income tax is paid on investment gains until money is withdrawn. Money can also be transferred from one investment option to another without penalty. That means an individual pays no taxes on the income and investment gains the annuity until the money is withdrawn. A person may also transfer his or her money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When money is taken out of a variable annuity, however, tax will be levied on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if it is held it as a long-term investment to meet retirement and other long-range goals.

2. Fixed Annuities

The annuitant receives a definite amount at regular intervals for a specified length of time, including the remaining lifetime of the annuitant. Fixed-dollar benefits mean that the number of dollars that the annuitant receives as each regular payment stays the same. Thus, a $600 a month annuity provides $600 a month for as long as the insurer promised.

3. Indexed Annuities

Indexed annuities, also called equity indexed annuities, are a newer type of retirement income that combines the best qualities of a fixed annuity with the greater income potential of a variable annuity. Indexed annuities' gains are based on the performance of certain indexes, such as the S&P 500, Dow Jones Industrial Average or others. They are like traditional annuities in that a premium payment is made to an insurance company and then the contract holder receives monthly, quarterly, or annual payouts. Indexed annuities offer a minimum fixed rate, so even in periods of poor index performance a certain rate of return is guaranteed. The payout is slightly different with indexed annuities. A person can choose to have a guaranteed income for life, but upon death, beneficiaries will receive the remaining value of the account. The value is determined by average index earnings on the death date or in some cases the anniversary of the creation of the annuity.

4. Fixed vs. Variable vs. Indexed

Fixed Annuity Considerations- Fixed annuities offer tax-deferred growth. The earnings on a contract will not be taxed until they are withdrawn. That means the capital that would ordinarily go to the tax collector will instead accumulate interest for the annuity owner. Over the life of the contract, that tax deferral can make a significant difference in earnings. Fixed annuities offer a fixed rate of return. The rate of return is known at the beginning of each period. Also, fixed annuities offer a death benefit. If the annuitant dies before payout, his or her beneficiaries will receive all the purchase payments plus any accumulated earnings.

Variable Annuity Considerations- Variable annuities offer many of the same benefits as fixed annuities, including tax-deferred growth and a death benefit. Unlike fixed annuities, however, the owner controls where the value in the contract will be invested. Within the limits of the investment divisions, the owner can be as aggressive or as conservative as he or she wants. This gives a variable annuity the potential for higher returns than a fixed annuity. This potential for higher returns requires the assumption of a greater risk of loss.

Equity-Indexed Annuity Considerations- Equity-indexed annuities, either immediate or deferred, earn interest or provide benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indices is Standard & Poor's 500 Composite Stock Price Index (the S&P 500), which is an equity index. The value of any index varies from day to day and is not predictable. When an equity-indexed annuity is purchased, and insurance contract has been bought- not shares of any stock of index.

<u>Currently-Available Annuity Products in the United States</u>

Virtually all of the annuity products marketed to individual annuity buyers in the U.S. are nominal annuities. They pay benefits that are not inflation-indexed. Two forms are common:

(a) level-payout annuities that provide a fixed payment, typically monthly, for as long as the annuitant is alive; and
(b) graded annuities paying benefits that increase over time at a pre-specified rate (e.g. at three or five percent per year).

The payout streams associated with these two types of policies differ, with the real value of payouts from a level-payout nominal policy declining faster than that from a graded annuity. A graded annuity does not offer inflation protection, of course, since the stream of benefits provided is not affected by the inflation rate over the contract's lifetime. An annuity may be purchased as either an individual policy or a joint-and-survivor policy. In the former case, benefit payments continue as long as the insured person is alive. In the latter case, benefits are paid for as long as either of two individuals is alive. Joint and survivor products vary in the ratio of the payout that second-to-die annuitant receives, relative to the payout when both annuitants are alive[1]. There are three common types of joint-and-survivor products (and several variants). One of the common types, a "100 percent survivor policy," provides the same benefit when both members of a couple are alive as when only one survives. A related policy, a "50 percent survivor policy," provides the survivor with half of the benefit that was paid when both annuitants were alive. The third common policy is a "50 percent contingent beneficiary policy." In this case, one of the annuitants is defined as the primary and the

[1] Brown and Poterba, 2000, "Joint Life Annuities and Annuity Demand by Married Couples" *Journal of Risk and Insurance* 67(4) 527-554

other as the contingent beneficiary. The full amount of the annuity payout continues for as long as the primary beneficiary is alive, even if the primary beneficiary outlives the contingent beneficiary. If the primary beneficiary predeceases the contingent beneficiary, the contingent beneficiary receives a payout equal to half of the primary beneficiary's payout.

A final factor affecting annuity products is their tax status, which has to do with the source of the funds used to purchase the annuity. In the U.S., contributions to employer-provided pension programs are subject to tax preferences as long as the plan meets regulatory standards.[2]

II Identification of the Parties to an Annuity

A. Rights and Obligations of the Annuity Owner

The person who purchases the annuity is the owner. The Owner may be more than one individual, or an annuity can be held by a person that is not a natural person, such as a corporation or a trust (special rules apply for "nonnatural" Owners). The Owner may also be the Annuitant or the Beneficiary. There is no limit to the number of Owners on any one contract.
The Owner has the following rights during the lifetime of the Annuitant:

- The right to designate the Annuitant.
- The right to designate the Beneficiary.
- The right to designate the Annuity Payout Starting Date.
- The right to designate the Settlement Option.
- The right to make early withdrawals or surrender the Annuity.
- The right to make an assignment or name another Owner.

For IRA, Keogh and teacher salary reduction plans the Owner and Annuitant have to be the same individual.

1. Entities Eligible for Annuity Ownership

The owner of an annuity is the party who pays the premiums for the contract. The owner of a nonqualified annuity is the person with total control of the contract prior to the annuitant's death. During the annuitant's lifetime and before the maturity date, the owner may exercise any of the rights listed above. In most instances, the owner will be one person, the person whose money buys the contract. Other forms of ownership may be desirable in limited circumstances.

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[2] McGill, Brown, Haley, and Schieber, Fundamentals of Private Pensions, 7th ed., Pension Research Council, U. of Pennsylvania, 1996, summarizing the regulations that govern qualified plans. Brown, Mitchell, Poterba, and Warshawsky 1999, "New Evidence on the Money's Worth of Individual Annuities" *American Economic Review*, 89(5) 1299-1318, analyze the tax treatment of distributions from qualified and nonqualified plans.

Joint ownership was more common in the past than today. Previously, a parent, age 50, might buy a deferred annuity with a child, age 25, as the joint owner and annuitant. The parent set the maturity date at the annuitant's 85th birthday. The child owned the contract after the parent's death and income tax deferral of up to 60 years was possible.

The Tax Reform Act of 1986 amended Inter Revenue Code (IRC) Section 72(s)(1) to require annuity contracts be distributed within five years. The law effectively disallows long periods of tax deferral through joint ownership arrangements.

Joint ownership and taxes- A joint annuity is a joint tenancy with right of survivorship. The arrangement has many ramifications. Signatures of both owners are required to make a policy change or accomplish a partial or total surrender. Distribution checks are payable jointly. Two 1099 forms are sent, one to each joint owner for one-half of the total distribution.

Joint ownership also may cause adverse gift and estate tax consequences. If a party purchases a joint annuity and contributes the entire premium, there is a taxable gift of one-half of the premium to the other owner. At the first owner's death, the contract's entire value will be included in the gross estate unless it is proved the survivor contributed to the contract. A special rule applies to married couples; one-half of the value is included in the estate of the first owner to die regardless of actual contribution.

Ownership by other than a natural person- Sometimes the prospect wants the annuity owned by a "non-natural owner," for example, a corporation or trust. Under IRC Section 72(u), the contract loses its tax deferral if a non-natural person owns it. The credited interest is reported as taxable income to the owner each year, which usually is not desirable. On the other hand, an annuity held by a trust as agent for a natural person is considered as owned by a natural person and therefore retains its tax-deferred status. A living trust may own a nonqualified annuity; this is not recommended for a married couple. As described above, if one spouse is the annuity owner and the other spouse the beneficiary, the beneficiary spouse may continue to defer taxation of the credited interest upon the owner spouse's death. If the policy is owned by a living trust, immediate taxation of the interest or other earnings usually cannot be avoided.

Ownership by a minor- Often, a parent or grandparent wants to purchase an annuity for a child's education with the minor child as owner. The transaction must accord with the applicable state's Uniform Gift to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA). An adult custodian is chosen; the ownership designation is "Jane Smith, custodian for Joe Smith, a minor, under the Uniform Transfers to Minors Act." Although the owner is an adult custodian, the child's Social Security number is used. The annuitant is the child and the beneficiary is the child's estate.

Contingent ownership- The selection of a contingent owner is important if the owner is not the annuitant. The death of an annuitant causes the immediate maturity of the contract. The annuity ceases to exist; all that is left is the death proceeds payable to the beneficiary. Conversely, when the owner dies but the annuitant still lives, the contract continues, but with a new owner. If an owner dies before the annuity starting date, IRC Section 72(s) requires the contract be distributed within five years. This five-year distribution rule does not apply if the spouse is the new owner.

2. Rights of Annuity Owner in Owner-Driven Contract

Before proceeding further it is important to understand three concepts that directly affect annuity contract structuring surrounding the event of death:

- **The Death of the Holder Rule** states that upon the death of a holder, death benefits of the annuity must and will be paid out. The “holder” is synonymous with the taxpayer/owner in any contract.
- **In the case of a non-natural trust-owner,** the annuitant is considered the owner, but only for death distributions. The IRS enacted these contract provisions after January 18, 1985 to prevent generational tax skipping. After April 22, 1987, the provision became applicable to “any holder.”
- **The Spousal continuation Rule [IRC 72(s)]** states that the deceased owner’s surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner can be lost.

In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse’s remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the “sole” beneficiary, which is a narrower interpretation of IRC. Death benefits can come in two forms:

1. The assets that have accumulated in the annuity investment itself, or,
2. Enhanced death benefits provide the potential of greater payouts based on certain contract guarantees. The enhanced death benefits feature offers another advantage over many other types of investments.

Owner-Driven- All annuity contracts are currently "owner-driven" in the sense that, under current law, the death of an owner requires a payout of an annuity, regardless of whether an annuitant is alive. Likewise, the death of an annuitant in most contracts currently issued (annuitant-driven) also requires a payout, per the terms of the annuity. It is the Internal Revenue Code that requires the payout at the death of the owner. The payout at the death of an annuitant is per the terms of the contract; it is the company’s determination of whether there will be a payout at the death of the annuitant. Under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an example:
Owner-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children
Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

Now, if the wife dies, the husband is generally able to name another annuitant without a payout or any other consequences. He simply names another annuitant. There is no step up in the value of the contract though, because it is owner-driven, and the owner did not die.

On the other hand, if the husband dies, then the contract must pay out, even though the wife/annuitant is still alive. Furthermore, since it is an owner-driven contract, the guaranteed death benefit applies. In this case, the children will have a death benefit of $750,000 to for which to select a distribution option.

3. Rights of Annuity Owner in Annuitant-Driven Contract

An annuitant-driven means that the contract requires a payout at the death of the annuitant. It is worth noting that there is another substantive point on how annuitant-driven contracts work. It determines when the guaranteed death benefits are applicable**.** In an annuitant-driven contract, generally only the death of the annuitant will trigger the guaranteed death benefit (as opposed to the standard death benefit, the current value). As mentioned above, under an owner-driven contract, only the death of the owner triggers the guaranteed death benefit. Here is an annuitant-driven example:

Annuitant-Driven Contract
Owner: Husband
Annuitant: Wife
Beneficiary: Children
Original Deposit/Guaranteed Death Benefit: $750,000
Current Value: $400,000

If the husband dies, the contract must pay out, per the IRC. However, because the contract is annuitant-driven (and the annuitant/wife is still alive), the standard death benefit of the current value is paid out. Therefore, the children will receive the current value of $400,000 (despite the fact that the annuitant/wife is still alive) for which they must select a distribution.

If the wife dies, then the contract must pay out. Furthermore, because the contract is annuitant-driven, and the wife/annuitant has died, the guaranteed death benefit of $750,000 is payable. However, the death benefit is paid to the children, as primary beneficiaries. Since the husband is still alive, but the children have received the proceeds, this may be deemed a taxable gift from the husband to the children of $750,000 at the death of the wife.

B. Rights and Obligations of the Annuitant

The annuitant is often characterized as the ‘measuring life’ under an annuity because the duration of the annuity payments made by the issuer (or the payment of a death benefit before annuity payments begin) may depend on how long the annuitant lives. His or her life measures the benefits under the contract.

1. Entities Eligible for Role as Annuitant

The annuitant is the person who receives annuity benefits at the contract maturity date. The annuitant is always an individual; it cannot be an unnatural person. The annuitant typically has no rights under an annuity contract. Upon the annuitant’s death, the contract matures automatically and the cash value is paid to the designated beneficiary. The annuitant can be the same person as the owner. Naming an annuitant other than the owner exposes the owner to two risks: first, the annuitant may predecease the owner, which causes contract maturity and distribution of cash value to the named beneficiary; second, the annuity benefits will be paid to the annuitant, not the owner, on the annuity starting date. Few companies accept joint annuitants. In any event, there is no reason to use this designation. Naming an annuitant other than the owner is justified only if the proposed owner is older than the maximum age permitted by the insurance company, age 75 years, for example. If the proposed wants to own an annuity, he or she must name some younger annuitant, such as a child.

2. Role of Annuitant in Owner-Driven Contracts

By “driven” it is meant that certain actions occur upon death that are beyond the control of named parties to the contract. In an Owner Driven contract, owners have all legal rights, and can change the designated annuitant as needed without any negative tax or penalties, as the contract specifies. Owner Driven contracts pay out only upon the death of the owner.

3. Role of Annuitant in Annuitant-Driven Contracts

In an Annuitant-Driven contract, owners can usually be changed. It is contract specific as to whether an annuitant can be changed once the contract is issued. Also, the contract will pay out upon the death of either the owner or the annuitant. In either form of contract, Owner-Driven or Annuitant-Driven, changes to beneficiaries (primary or contingent) may always be made. A key to death benefit payouts is to know on whose life the enhanced benefits are actually based. The owner or the annuitant can trigger enhancement of death benefits.

- Owner-Driven contract, death benefits are based on the death of the owner.
- Annuity-Driven contract, death benefits are based upon the death of the annuitant.
  - On the owner’s death, distributions will occur as “distributions of annuity assets.”
  - On the death of the annuitant the distributions will come out in the form of “death benefits” (enhanced or not).

The different handling can bring about adverse income tax, gift tax, and premature distribution penalties to various named parties to the annuity contract.

C. Rights and Obligations of the Insurance Company

Qualified and nonqualified annuity contracts allow the contract holder to defer taxes on earnings credited under the contract. Qualified annuities (e.g., annuity contracts purchased through a 401(k) or 403(b) pension plan or an individual retirement account) also allow the deferral of income taxes on principal invested in the annuity. IRS guidelines must be followed to determine the tax status (qualified or nonqualified) of an annuity. Since annuities are insurance products, they are also subject to regulation under the state's Insurance Code. The Insurance Code places additional responsibilities on insurers offering qualified or nonqualified annuities to seniors. With regard to the rights and obligations of insurers, a ‘senior citizen’ is defined as an individual who has reached the age of 60 at the time of an annuity contract purchase.

1. Rights and Obligations of Insurer

For both Qualified and Non-Qualified policies, obligations that fall on the insurer issuing life or annuity policies issued to a senior citizen are as follows;

1.) **Return Policy-** For all policies issued after July 1, 2004, the insurer must notify the purchaser of the return policy. Seniors are allowed a 30-day free look. For individual policies, all premiums and fees must be returned within 30 days. The written notice must be displayed in a prominent manner on the policy's cover page or jacket or on a sticker affixed to the cover page or jacket.
2.) **Refunds and Cancellations-** For annuity contracts and variable annuity contracts which the owner has not directed that the premium be invested in mutual funds underlying the contract during the cancellation period, return of the policy during the cancellation period shall have the effect of voiding the policy from the beginning, and the parties shall be in the same position as if no policy had been issued. All premiums paid and any policy fee paid for the policy are to be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy. In the case of a variable annuity for which the owner has directed that the premium be invested in the mutual funds underlying the contract during the 30-day cancellation period, cancellation shall entitle the owner to a refund of the account value.
3.) **Non-Guaranteed Values-** The insurer must cause to be displayed on the face of any policy illustrations a notice regarding nonguaranteed values and identify those values as being such. Preprinted policy illustrations must contain this notice in 12-point bold print with at least one-half inch space on all four sides, printed on the illustration form itself or on an attached cover sheet, or in the form of a contrasting color sticker placed on the front of the illustration. All preprinted illustrations containing nonguaranteed values shall show the columns of guaranteed values in bold print. All other columns used in the illustration shall be in standard print. "Values" as used here includes cash value, surrender value, and death benefit.
4.) **Annual Statement-** When an insurer provides an annual statement, the duty arises to supply current accumulation and cash surrender values. Whenever an insurer provides an annual statement to a senior citizen policyowner of an individual life insurance policy or an individual annuity contract issued after January 1, 1995, the duty arises for the insurer to also provide the current accumulation value and the current cash surrender value of the contract.
5.) **Surrender Charge-** Prominently disclose the existence of any surrender charge. The statement regarding surrender charge must make known the applicable surrender charge period and penalties associated with contract surrender.
6.) **Replacement Policy-** Follow (and make certain agents follow) guidelines regarding replacement policy as found in the Texas Insurance Code. If a replacement policy is involved, the replacing insurer shall provide in the policy or a written notice that the applicant has a 30-day right to the refund of premiums. In the case of variable annuity contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid.

2. Policy Cancellation and Refunds

Insurance products sold to individuals 60 years of age or over in many states shall provide an examination period of 30 days after receipt for the purpose of review of the contract. Return during this "free look" period voids the policy, with premiums fully refundable. If premiums or fees are not refunded in a timely manner (no later than 30 days) interest shall be due on the outstanding balance at the statutorily prescribed rate.

Policies and certificates are to note this right of return on the cover page in at least 10-POINT UPPERCASE TYPE.

Policies must have the cancellation/refund notice printed or attached to it. Delivering or mailing it to the insurer or agent from whom it was purchased can cancel the policy. The insured may return the policy by mail or otherwise during the 30 day period.

If a variable annuity has been purchased, the premium may be invested only in fixed-income or money market funds unless the investor specifically directs otherwise. Return of the policy within the 30 days shall have one of the following effects;

1.) If the owner has not directed the premiums be invested in mutual funds underlying the variable annuity contract the cancellation has the effect of voiding the policy from the beginning with all premiums and fees refunded by the insurer within 30 days of cancellation of the policy
2.) If the owner directed premiums be invested in the mutual funds, cancellation entitles the owner to a refund of the account values within 30 days of cancellation notification.

If a replacement policy is involved, the replacing insurer shall provide in the policy or a written notice that the applicant has a 30 day right to the refund of premiums. In the case of variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, return of the contract during the cancellation period entitles the owner to a refund of account value and any policy fee paid.

D. Rights and Options Available to Beneficiaries

1. Effects of DRA on Beneficiaries

There are possible effects on the rights of beneficiaries under the changes to the law brought about by the Federal Deficit Reduction Act (DRA) of 2005. The DRA contains numerous requirements related to annuities. Under this bill, the state is required as a result of providing Medicaid for home and facility care to an individual, to become a remainder beneficiary of annuities purchased by an individual or his or her spouse in which the individual or his or her spouse is an annuitant (a remainder beneficiary is the entity entitled to receive what remains of the principal after the death of the beneficiaries). There are exemptions from this requirement that are beyond the scope of this book.

2. Settlement Options Available to Beneficiaries

Annuity structures should be as simple and clean as possible, which, in most cases, means avoiding joint owners and annuitants. In the case of spouses, naming anyone other than the surviving spouse as primary beneficiary should be avoided, or if done, a lot of caution should be used.

a. As a Surviving Spouse

The Spousal continuation Rule [IRC 72(s)] states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. However, not all insurance annuity contracts offer the spousal continuation provision. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner is usually lost. In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC.

Under the tax code, the spouse as the beneficiary of an annuity contract may choose not to accept the death benefit and instead may choose to continue the annuity contract with the insurance company. The insurance company will change the owner from the deceased person's name to that of the surviving spouse. The surviving spouse now has the right as the owner to name a new beneficiary. This right exists whether the policy is a nonqualified annuity contract or a qualified annuity contract.

b. Entity Other Than Surviving Spouse

Problems can and do arise when multiple primary beneficiaries are named, or primary beneficiaries other than a spouse are named. Therefore, such structuring arrangements require great care and caution. If the death occurs prior to the time that annuitization payments have begun and an individual who is not a spouse is the beneficiary, the contract proceeds payable to that non-spouse beneficiary must either be distributed (1) within 5 years of the death of the annuitant/owner or (2) as an annuity based on the life expectancy of the beneficiary, as long as payments begin within one year of the date of the owner's death.

Trusts can be designated as beneficiaries or even as contingent beneficiaries of an annuity. First, there is no need to do this because annuities pass probate free, and second, trusts do not allow for any form of spousal continuation or lifetime annuitization because a trust is considered to be a "non-natural person." (For more information on this, see the Non-Natural Person Rule that applies to contributions into annuities after February 28, 1986). Third, trusts limit payout options to only the first two options listed above resulting in a 50% reduct6ion in payout flexibility. This impedes income tax efficiencies on lesser-taxed distributions, which otherwise could be stretched out. When making a trust the owner it is important to know whether the insurance company that's issuing the annuity views the trust as either a "natural" or "non-natural person" especially in revocable trusts (living trusts) where there are often spouses involved. If they view the owner/trust as a trust, they will not allow for spousal continuation; hence, another problem with making a trust the owner of an annuity. There is no look-through provision on non-qualified annuities (i.e. where the IRS will "look through" the grantor/trustee designation and recognize the spouse for spousal continuation rights). The "look-through provision" applies only to IRS-provided rationale for IRAs/qualified plans when a trust is the beneficiary. Those wishing to deploy this tool should proceed very carefully when using a trust as any part of an annuity structure. Advisors should require and obtain a written letter of instruction from the client's attorney on exactly how they want the structuring set up under an annuity contract. Annuities are a sound investment for many, but as seen in the examples in this article, they must also be properly structured to achieve their fullest potential.

III. How Fixed, Variable, and Index Annuity Contract Provisions Affect Consumers

A. Identifying and Discussing Contract Provisions

The provisions described here are all common but every one is not available in every contract. **Purchasers must read the contract!** The terms and conditions should be understood by the buyer before completion of the sale. The descriptions here are examples only. Features included in a contract will be defined in the contract. Thus the “owner,” “annuitant,” and “beneficiary” will all be spelled out in the contract definitions.

Contract loans- A loan provision may be included in an annuity contract. In general, this feature allows one to borrow up to a specified amount of the annuity’s accumulated value. Since it is a loan, interest will accumulate and it most likely will be to the owner’s advantage to repay it. Like the withdrawal privilege, a loan provision can give some liquid features to an annuity.

Return of principal guarantee - Surrender of the contract should be avoided whenever possible, but individual circumstances may leave a person with no other choice. If an annuity must be surrendered, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums (minus any prior partial withdrawals). It applies even if the amount is greater than the cash surrender value defined by the contract.

Minimum Initial Premium- Each annuity contract will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places inside the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions.

Issue Age Each annuity contract will have a provision for the minimum and maximum age of the owner or the annuitant who can purchase the contract. Generally, the insurance company is more interested in the age of the annuitant for purposes of mortality. But the issue age of the owner is also important because of legal issues related to minors who purchase the contract. Normally, an insurance company does not want a minor to own one of its policies because of the minor’s legal right, upon reaching the age of 18, to rescind a purchase made while he or she was a minor. Usually, annuity contracts allow annuitants between the ages of 18 and 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90. The reason for the qualified funds’ limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

Options Involving the Spouse- The spouse as the beneficiary of an annuity contract may choose not to accept the death benefit and instead may choose to continue the annuity contract with the insurance company. The insurance company will change the owner from the deceased person's name to that of the spouse.

Settlement Options- Deferred annuity contracts also include provisions for taking the money out of the contract at some future contract-owner-determined date- called annuitization- or at some other agreed-upon date. These optional modes of settlement may be taking a lump-sum withdrawal, leaving the proceeds in the contract at interest, choosing fixed-period or fixed-amount payments, or selecting the various life contingent or joint-life-contingent options. Little attention is given to these contractual provisions in periods of high interest rates. As interest rates fall and longevity has increased, the guaranteed lifetime annuitization factors and interest rate guarantees of 3% have real value in comparison to the guarantees in new annuity contracts. The minimum payout rates for settlement options are listed in the annuity policy. In a normal economy, these rates are much lower than what the annuity company can afford to pay. Therefore, it is important for the owner to look at the guaranteed settlement option rates in the policy and compare those rates to the current offerings from the insurance company to be sure to obtain the best rates available. Surrender of the contract should be avoided whenever possible, but circumstances may leave the policyholder with no choice. If someone must surrender his or her annuity, this feature gives assurance that the company will pay no less than the total dollars that have been paid in premiums — minus any prior partial withdrawals already taken. It applies even if the amount is greater than the cash surrender value defined by the contract.

Death Benefits- If the entire annuity value is not consumed during retirement, when the annuitant dies, the annuity will still be in force. Annuities contracts have provide for a beneficiary or some other party to legally receive the values at the annuitant's death. The death benefit can be classified in one of two ways depending on how the death benefit is payable in the policy: Policies are either annuitant driven or owner driven.

1. Issue Ages

The insurance contract has the basic elements of any other contract. Those elements are summarized (not in correct order) by the acronym COALL. It stands for Consideration, Offer, Acceptance, Legal capacity to contract, and Legality of subject matter. Notice should be given to the fact that in writing is not an element that must be present to have a valid contract. This is important where the concepts of waiver and estoppel are concerned, but beyond the text's scope. Generally speaking, a person has the legal capacity to contract when he or she reaches the age of majority, 18 years. In common law, persons under 18 can contract, but the contract is voidable at his or her discretion.

At the upper-end of the age spectrum contracts allow annuitants up to age 85. Some companies may stop issuing annuities at age 70 or 75; other companies will issue annuities up to age 90. In addition, the insurance company may limit the issue age based on the type of funds in the annuity. Qualified annuity contracts typically carry a maximum issue age of 70, while nonqualified annuities will be issued to age 85 or 90.

The reason for the qualified funds' limitation is based on the minimum distribution requirements for qualified annuity contracts. The tax code stipulates that qualified plans distribute a certain percentage of the account after the owner reaches age 70 1/2.

With respect to insurance and annuity contracts, the common law provisions have been modified by statute. An insurance or annuity contract may be issued to or indicate the named insured as a person under the age of 18 for the benefit of the minor or for the benefit of the parents, spouse, child, or siblings of the minor. Likewise, a contract can be issued to a minor, subject to written consent of a parent or guardian, upon the life of any person in whom the minor has an insurable interest for the minor's benefit or such minor's parents, spouse, or siblings. Subject to approval of a parent or guardian, a minor may give a valid discharge for any benefit accruing or for any money payable. Contractual matters involving minors under the age of 16, as determined by the nearest birthday (meaning 15½); need the written consent of a parent or guardian.

2. Maximum Ages for Benefits to Begin

Non-Qualified Annuities- Annuities are based on life expectancy. Being non-qualified, the tax code specifies no maximum age limitation for contributions or withdrawals. It is at the issuer's discretion as to age at which payments must begin. Once annuitization occurs, payments must be spread evenly over the life expectancy of the annuitant.

Qualified Plans- To make sure that most of the retirement benefits are paid to the plan participant during his or her lifetime, rather than to subsequent beneficiaries after an individual's death, the payments that are received from qualified retirement plans must begin no later than the plan participant's ***required beginning date*** (defined later). The payments each year cannot be less than the ***minimum required distribution***.

If the actual distributions to an individual in any year are less than the minimum required distribution for that year, he or she is subject to an additional tax. The tax equals 50% of the part of the required minimum distribution that was not distributed. A qualified retirement plan includes a qualified employee annuity plan and a tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

Required beginning date- Unless the rule for 5% owners and IRAs applies, the plan participant must begin to receive distributions from the qualified retirement plan by April 1 of the year that follows the ***later*** of:

- The calendar year in which the subject individual reaches age 70½, or
- The calendar year in which the person retires.

5% owners- If a person is a 5% owner of the employer maintaining the qualified retirement plan, the plan participant must begin to receive distributions from the plan by April 1 of the year that follows the calendar year in which he or she reaches age 70½. This rule does not apply if the retirement plan is a government or church plan.

A person is a 5% owner if, for the plan year ending in the calendar year in which he or she reaches age 70½, the person in question owns (or is considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

Age 70½ -A person reaches age 70½ on the date that is 6 calendar months after the date of their 70th birthday. For example, if your 70th birthday was on June 30, 2004, you reached age 70½ on December 30, 2004. If your 70th birthday was on July 1, 2004, you reached age 70½ on January 1, 2005.

Required distributions- By the required beginning date, as explained above, the plan participant must either:

1) Receive his or her entire interest in the plan (for a tax-sheltered annuity, the entire benefit accruing after 1986), or
2) Begin receiving periodic distributions in annual amounts calculated to distribute the entire interest (for a tax-sheltered annuity, the individual's entire benefit accruing after 1986) over a person's life or life expectancy or over the joint lives or joint life expectancies of the plan participant and his or her designated beneficiary (or over a shorter period).

3. Premium Payments

Incorporated life insurers that issue policies on the reserve basis can collect premiums in advance. Insurers are limited by statute as to the amount of advance premium that can be collected. However, the Insurance Code does not limit the ability of insurers to accept payment under an agreement that provides for an accumulation of such funds for the purpose of purchasing annuities at future dates.

4. Surrender Charges

Annuity contracts carry a surrender charge. A typical contract could have a surrender charge in effect over the first 10 years, but decreasing in amount each year. The contract will explain how the surrender charge applies. An annuity is a long-term investment. The surrender charge discourages the annuity owner from using the funds as a piggy bank. It also allows the insurer to cover the expense of selling and issuing the contract. The charge is usually a percentage of either the fund's accumulated value or the total premiums paid. Surrender charges are generally waived under certain circumstances, such as death or disability of the annuitant.

a. Market Value Adjustment

Market value adjustments are features added to some deferred annuities to discourage surrenders prior to their contractual maturity date. If, during the contract period and before the maturity date, money in excess of any free-corridor amount is withdrawn, it is subject to a market value adjustment. The market value adjustment is an increase or decrease in the annuity's value, depending on the level of the general economy's interest rates relative to the interest rates of the contract from which the withdrawal is taken. Annuities with market value adjustment features often offer a slightly higher interest rate than a comparable fixed annuity without such features. The market value adjustment works in the annuity contract in a manner similar to the way individual bond prices fluctuate. For example, if a contract owner has an annuity with a contractual interest rate of 8 percent with 5 years left prior to its maturity date, and similar contracts are being issued with 4 percent interest rates, the contract owner can expect some gain upon early surrender. This is because the surrender will relieve the insurance company from its 8 percent obligation in a market where interest rates have decreased to 4 percent. On the other hand, if the opposite occurred and the old contractual obligation was for 4 percent in a current interest rate market of 8 percent, the contract owner can expect a negative MVA and therefore will receive a smaller

b. Impact of Surrender Charges on Principal

Surrender charges are a reduction of principal. They do not reduce the interest earned portion of an annuity. Subsequent earnings will be reduced because of the reduction of principal. The idea is to make it less tempting for annuity owners to draw funds out of the contract and allow the insurer to recover costs associated with the contract. Surrender charges are commonly deducted from withdrawals. There may also be a limited free withdrawal privilege.

c. Surrender Charge Waivers

With a waiver, access can be provided to an annuity before retirement. Some annuities contain a waiver that triggers payments not subject to the usual surrender fees.
Nursing Home- One insurer might require a 90-day nursing home confinement before benefits are activated, while another might call for 60 days. With a nursing home waiver, surrender fees will not be charged and access is granted to some or the entire annuity if an individual is put in a nursing facility. A 90-day confinement period before benefits begin may be typical, longer periods could apply. A doctor will normally be asked to then submit an attending physician's statement, along with a completed claim form.
Terminal Illness- The same can hold true if a policyholder becomes terminally ill, thus allowing access to money when it may be needed most. The definition of terminally ill may vary from company to company; it's generally a condition that will result in death within six months to a year.
Unemployment- This is another condition for which a waiver of surrender charges could be added.
Disability- With this type of waiver, one company may consider an individual disabled if he or she is unable to work in any occupation, while another may require only that a person is unable to work in their current vocation The risk of disability is greater than the risk of death at all ages between 20 and 65. It is prudent to protect oneself financially if disability does occur, and that includes annuity considerations.
Charges and Fees- In most cases, there's no extra charge for such crisis waivers because they're built into the contract when purchased. Variable annuity contracts may offer crisis waivers for an additional expense. Certain tax consequences could apply to such withdrawals. The insurance professional should advise clients to check with a tax advisor before withdrawing funds from an annuity.

d. Required Notice and Printing Requirements

Generally speaking, when penalties are associated with surrender of the contract the notification requirement can be met through a notice in 12-point bold print on the cover page making the mandated disclosures or by indicating the location of this information in the policy. Notice information can be found the section addressing replacement notification.

Annuity contracts for senior citizens that contain a surrender charge period need to disclose the surrender period and all associated penalties in 10-point print on a notice accompanying the policy. (TAC 3.9503)

5. Policy Administration Charges and Fees

Every insurer that sells annuities charges fees which are connected to the contract. These fees cover the company's costs of administering the annuity. Annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. This contract provision less has become less common in newly issued annuity contracts.

6. Withdrawal Privilege Options

In the event the policyowner needs to access funds prior to maturity, the owner has the option of requesting a withdrawal, also called a partial surrender. Withdrawal provisions in deferred annuity contracts allow the policyowner limited withdrawal of funds prior to maturity of the contract. The surrender or withdrawal, if made during the surrender charge period, is normally subject to a surrender charge. If the withdrawal is requested after the policy is beyond its surrender charge period, the policyowner should be able to access the withdrawal without any charges imposed by the insurance company. Withdrawals are not expected to be repaid to the annuity contract. With flexible-premium policies, the withdrawal can later be paid into the annuity policy as new premiums. Annuity policies do not generally have loan provisions available to the policyowner due to tax consequences.

Free-Corridor Amount- To accommodate a contract owner's unforeseen need for money, practically all companies provide a free withdrawal corridor. A free corridor is some maximum amount of money that a contract owner can withdraw from the contract each year without incurring a surrender charge. If a contract owner elects to make an early withdrawal of just part of the funds in an annuity contract before the end of the surrender charge period, there is likely to be a free-corridor amount that he or she can withdraw without any charge. Normally, this amount is about 10 percent of the last year's accumulation value or 10 percent of the initial premium paid. However, some contracts do not allow any withdrawals without charge; the most generous allow withdrawals of up to 15 percent per contract year without charge. Amounts in excess of the free corridor amount are subject to proportional surrender charges. A prospective purchaser should carefully examine surrender charges and free-corridor provisions.

B. Income Distributions

How income distributions are taxed depends on whether they are *periodic payments* (amounts received as an annuity) that are paid at regular intervals over several years or *nonperiodic payments* (amounts not received as an annuity). This material is presented as introductory material only. Tax statutes can change every year. **IRS publications or a tax professional should be consulted before completing tax returns**

1. Introduction to Application of a Split Annuity

A split annuity involves simultaneously purchasing at least two annuities with a single premium payment. The term “split annuity” involves the splitting of a lump sum of money between two or more annuities. A split annuity is a retirement planning approach aimed at providing current income, preserving principal value or capital. An individual simultaneously buys an immediate annuity for a term certain and a deferred annuity for a single premium. The premium is divided between the immediate and deferred annuities so that, at current interest rates, the deferred annuity’s accumulation value at the end of the immediate annuity’s term certain will approximately equal the total original premium.

For retirement planning purposes, the split annuity can provide a larger monthly income than a CD, and if properly structured eliminates investment risk. The split annuity combines two types of annuities, an immediate and deferred annuity. The immediate annuity will pay a guaranteed monthly income while the deferred annuity allows the money to be left to grow without being inhibited by income taxes. The money that is growing inside the deferred annuity replaces the money that is being paid to the annuitant from the immediate annuity. This enables the retiree to maintain a level investment account, similar to a CD or an investment in a bond.

2. Introduction to Various Settlement Options

Settlement options are the various methods by which an annuity can be liquidated. It is the payment option. Generally, the annuity owner makes the settlement option selection. It can be made when the contract is purchased or delayed until the time benefit payments begin.

a. Life Annuity

The life annuity is a general payout category in which the payout is guaranteed for life. Sometimes known as a straight life annuity, the life annuity pays a benefit for as long as the annuitant lives, and then it ends. Whether the annuitant lives past 100 years of age or dies one month after the annuity period starts, the annuity payments will continue only until he or she dies. In other words, there is no guarantee as to the minimum amount of benefits under a life annuity.
There is a risk to the annuitant that he or she might not live long enough once the annuity period begins to collect the full value of the annuity. If an annuitant dies shortly after benefits begin, the insurer keeps the balance of the unpaid benefits. This settlement option will pay the highest amount of monthly income to the annuitant because it's based only on life expectancy with no further payments after the death of the annuitant.

b. Joint Survivor

Joint life annuities protect the annuitant and a coannuitant (such as a spouse) against outliving their resources. With a joint life and survivorship (or last survivor) annuity, there are more than one (usually two) annuitants, and both receive payments until one of them dies. A stated monthly amount is paid to the annuitant and upon the annuitant's death, the same or a lesser amount is paid for the lifetime of the survivor. The joint-survivor option is usually chosen as one of three alternatives: joint and 100% survivor, joint and two-thirds survivor, or joint and 50% survivor. The reasoning is that the survivor of the two annuitants may see a reduction in living expenses and not need as much income to live as before the first annuitant's death. To counter that reasoning, depending upon the remaining annuitant's other income, remaining lifespan, and inflation rate, the remaining annuitant may not see a reduction in expenses at all.

c. Period Certain

The easiest settlement concept is the fixed period annuity. The fixed period settlement option allows the annuitant to receive the accumulated value in the annuity over a set number of years. So, the annuitant could elect to receive the accumulated value over a five or ten year period. The formula to use to determine the periodic value of the payments is the same as the loan payment formula;

Calculating the Payment Amount per Period

The formula for calculating the payment amount is shown below.

$$A = P\frac{r(1+r)^n}{(1+r)^n - 1}$$

where

A = payment Amount per period
P = initial Principal (loan amount)
r = interest rate per period
n = total number of payments or periods

If they have not already done so, the insurance professional should become familiar with present/future value concepts. The present value concept and time value of money calculations can be practiced on the Internet or on a reasonably-priced hand-held business function calculator.

d. Cash Refunds

A cash refund annuity refunds the unpaid nominal amount of the premium in the event that the annuitant dies before the full amount of the initial premium has been distributed. The differences in purchase rates are a function of time and interest rates. If the annuitant dies before receiving total income at least equal to the premiums paid, the beneficiary receives the difference in a lump sum.

3. Advantages and Disadvantages of Annuitization Options

Many variables are involved in determining the proper annuitization option for individual purchasers of annuity products, including their Social Security income, other annuity income sources, out-of-plan retirement savings, other assets (real estate, etc.) and participants' overall health. The complexities involved in evaluating each individual's situation mean that any default requirement would need to be considered carefully. Two things are certain; the individual will have to decide a future course of action based on today's knowledge, and hindsight will always be 20-20. In any situation where annuitization is by choice (as opposed to being the only option for all, as in many defined benefit plans), adverse selection will increase costs as the healthier people select annuities at a higher rate. That is, those who think they will live longer will opt for straight annuitization. That cost will be subsidized by those who believe hey will not survive as long; putting a premium on survivor-oriented options.

C. Contract Provisions Typically Common to Fixed Annuities

Insurance companies develop and sell annuity contracts. The contract between the insurer and the client describes what happens during the accumulation and distribution phases of the contract. It sets forth the rights and obligations of the contracting parties. Generally speaking, the client agrees to be a purchaser and to place money into an annuity contract in order to have the rights offered under the contract. The insurance company agrees to the obligations because it has the capacity to meet those obligations and is in the business of doing so as a for-profit enterprise. Although insurance companies are regulated by the individual states and contract forms have to be acceptable to each state, in the interest of efficiency, there is a great deal of standardization in all annuity contracts.

1. Death Benefits

All deferred annuity contracts provide for a death benefit prior to the annuity starting date. Death payments after the annuity starting date would be a form of settlement option. Tax code changes in 1985 provide that a death benefit is payable if any owner of the annuity dies before the maturity date. Some annuities provide that a death benefit is payable only if the owner dies, so long as the contract provides for a new annuitant to take the place of the deceased annuitant.

a. Lump Sum vs. 5-Year Payout

The amount of the death benefit payable under a deferred fixed annuity will normally be the accumulated value of the contract, possibly reduced by any applicable surrender charge. Variable annuities also provide a death benefit, based on total premiums paid or the annuity's account value. Federal tax law calls for the distribution within five years of a contract's entire cash value if the 'holder' (owner) dies before the maturity date. The entire death benefit must be distributed within five years of the date of the owner's death.

b. Provisions

There is an exception to the five-year rule, if the death benefit is paid as an annuity over the life, or a period not longer than the life expectancy, of the beneficiary and the payments start within one year of the owner's date of death. If an annuity contract has joint owners, the distributions at death rules are applied upon the first death. Under a special exception to the distribution at death rules, if the beneficiary is the surviving spouse of the owner, the annuity contract may be continued with the surviving spouse as the owner. If the owner of the annuity is a non-natural owner, then the annuitant's death triggers the distribution at death rules. In addition, the distribution at death rules is also triggered by a change in the annuitant on an annuity contract owned by a non-natural person.

2. Charges and Fees

Annuity contracts will designate a minimum premium that the policyowner must pay to purchase an annuity. Normally these amounts are in the $5,000–$10,000 range for single-premium policies and $25–$50 per month for flexible-premium policies. Insurance companies may designate a different minimum amount, depending on the type of funds the client places in the annuity. For example, a policy might show a minimum premium of $1,000 for a qualified single-premium annuity but still keep the nonqualified annuity minimum premium at $5,000. Lower premium amounts are common for qualified contracts so that the annuity can accept small annual IRA contributions. Deferred annuities may charge a nominal annual contract maintenance fee such as one percent of the cash value not to exceed $20–$50. These fees are usually deducted from the annuity cash values, and they will often expire when the contract accrues a certain amount of cash value such as $5,000 or $10,000. Recent competition among annuity products, however, has made this contract provision less common in newly issued annuity contracts.

3. Interest Rates Strategies

The amount of interest the annuity product earns is of primary importance to the owner of the policy. In addition, because the initial interest rate is guaranteed for some period of time in the terms of the contract, the length of the guarantee period is critical. A potential annuity purchaser needs to know how the insurance carrier has typically treated its policyholders in terms of renewal interest rates. These are the interest rates declared once the initial guaranteed interest rate period has expired.

Two questions a person should ask when considering the purchase of an annuity are;

- What is the current interest rate being paid?
- For what length of time is that interest rate guaranteed? Will it be one year, two years, five years, or longer?

4. Crediting Methods

Companies use several methods to establish the current interest rate to be credited to their accumulation accounts.

a. Portfolio rates

The portfolio average method credits all policyholders with a composite rate of interest that reflects the company's earnings on its entire portfolio of investments during the year in question. During periods of rising interest rates, the interest credited to the "new" contributions received during the year will be heavily influenced by the interest earned on investments attributable to "old" contributions; those received and invested 5, 10, 15 or more years earlier. The interest credited will therefore be stabilized. Thus, when interest rates are rising, contributions made in the year 199X earn 4%, funds placed in the accounts (old or new) in year 199Y earn 4.5%, and all funds in year 199Z earn 5%. When interest rates are falling, contributions made in the year 200X earn 4%, funds placed in the accounts (old or new) in year 200Y earn 3.5%, and all funds in year 200Z earn 3%.

b. New Money Rates

With new money rates (sometimes referred to as the 'banding'), the contributions made by all policyholders in any given period are banded together and credited with a rate of interest consistent with the actual yield that such funds obtained during that period. If a company's average return on all money is 4% in a given period, the contributions made by all participants during the current period may be credited with 5% if the company was able to make new investments that, on average, returned in excess of 5% interest. Additionally, the interest rate credited on those contributions should continue to earn 5% until the monies are reinvested. After reinvestment, the interest on these contributions will change and the rate credited to contributions banded in the following period could be higher or lower.

With increasing interest rates and reinvestment of assets every year, an investment in year 199x might earns 5% (the new money rate for that year) and then earn 5.25% in the second year and 5.5% in the third year. An investment in year 2 earns 10% (the new money rate for that year) and then earns 10.25% in the second year and 10.5% in the third year. Finally, an investment in year 3 earns 11%.

c. First Year Bonus 'Teaser' Rates

This is additional interest granted to new purchasers of annuities that is paid on top of the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. These annuities are often used to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. A Bonus rates is an incentive to get people to purchase an annuity. Big bonus incentives mean bigger constraints on when that bonus will be applied or earned. Any forfeiture and possibly even a withdrawal prior to the end of the surrender charge period could void the bonus. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties. Bonus annuities can bear much higher surrender charges than those annuities found without the feature.

d. Annualized Interest Rate Calculations on Bonuses – Fixed Accounts

Bonus interest rates are extra amounts of interest granted to new purchasers of fixed-interest deferred annuities that are paid in addition to the normal stated current interest rate. These amounts are usually based on the total dollars contained in the contract during its first year. Bonus plan annuities are designed to attract money from existing annuity contracts, which still may be subject to a surrender charge, by paying extra interest in the first year. This extra interest (the bonus) is designed to offset some of the loss caused by the termination of the old policy. Potential purchasers must understand that these bonuses have an indirect cost behind them. Thus, the agent must be sure to tell prospects of any circumstance in which the bonus will not be paid, such as early termination or surrender. Interest rate bonuses often encourage replacement of annuities. The policyowner is lured by the high interest rate and a bonus above the normal current interest rate; the annuity owner may feel that the bonus will help to offset any surrender penalties he or she may incur. Bonus annuities will bear much higher surrender charges than a nonbonus product, putting the policyowner at a still greater disadvantage.

5. Minimum guaranteed Interest Rates

The Standard Nonforfeiture Law (SNFL) for annuities was developed by the NAIC in the late 1970's. The model law mandates a 3% minimum guaranteed interest rate for fixed annuities. This minimum caused solvency concerns to emerge among insurers offering annuity products as interest rates drifted lower through the first half-decade of the beginning of the 21st Century. Many of the investments of life insurers do not provide yields sufficient to support a 3% guaranteed yield.

In general the mechanics of rate determination can be outlined as follows:

The minimum nonforfeiture amount at any time at or prior to the commencement of any annuity payments shall be equal to an accumulation up to that time, at the **rates of interest indicated below**, of the net considerations paid prior to that time, decreased by any prior withdrawals or partial surrenders, an annual contract charge (currently $50), and state premium tax paid by the company for the contract, and any loans or indebtedness outstanding. The net considerations for a given contract year used to define the minimum nonforfeiture amount is 87.5 percent of premium during that contract year.

Interest rates- The interest rate used in determining minimum nonforfeiture amounts is the lesser of 3% or the following:

- The five-year Constant Maturity Treasury Rate reported by the Federal Reserve as of a date, or averaged over a period, rounded to the nearest one-twentieth of 1 percent, no longer than 15 months prior to the contract issue date or redetermination date, reduced by 125 basis points, where the resulting rate is not less than 1 percent.
- The interest rate applies for an initial period and may be redetermined for additional periods. The redetermination date, basis, and period are to be stated in the contract.

If a contract provides substantive participation in an equity-indexed benefit, it may increase the reduction described above by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date and at each redetermination date thereafter, of the additional reduction may not exceed the market value of the benefit.

D. Contract Provisions Common to Variable Annuities

As the name implies, with a variable annuity the annuity holder receives varying rates of return on the funds placed in the annuity. The return is dependent on the risk taken by the annuity holder and the economic performance of the various components of the annuity portfolio.

1. How They are Sold and License Requirements

Variable annuities are structured to have both an investment component and an insurance element. During the accumulation phase, premium payments are used to purchase "investment units," the price depending on the value of the variable annuity's underlying asset portfolio. A variable annuity is considered to be a security under federal law and is subject to regulation by the Department of Insurance and the Securities and Exchange Commission. Anyone selling a variable annuity must have the required securities licenses. Buyers of this product must be provided with a prospectus, a detailed document which provides information on the variable annuity and the investment options available. By investing in a product whose market value can fluctuate, the assumption of risk by the holder of the annuity is a key element of the variable annuity.

a. General vs. Separate Accounts

Variable annuities allow money to be invested in insurance company "separate accounts" (which are sometimes referred to as "subaccounts" and in any case are functionally similar to mutual funds) in a tax-deferred manner. In addition, many variable annuity contracts offer a guaranteed minimum rate of return (either for a future withdrawal and/or in the case of the owner's death), even if the underlying separate account investments perform poorly. The separate account provides the variable investment options and along with the general account provides the foundation of a variable annuity. The investment fund options (often dozens of mutual funds) are referred to as subaccounts. In contrast to the general account, the separate account is not guaranteed by the insurance company. The returns of the subaccounts are variable rather than fixed, so the contract holder rather than the insurance company assumes market risk. The separate account is “separate” from the general assets of the insurance company, so there is no credit risk in the event that the insurer becomes insolvent.

b. Variable Options

There are several contract provisions common to variable annuities. Not all annuities will contain all provisions. It is important that the purchaser understands the several options available and makes an informed decision about which features he or she wants. Variable annuities feature a wide range of investment options during the accumulation phase. Like mutual funds, there are aggressive, bond, large cap, small cap, technology- the list goes on. The investor will be able to find something that works for their particular risk appetite and portfolio. Variable annuity contract holder settlement options are much like those offered under other annuity contracts. Settlement options are the methods by which the annuity owner can select to receive payments of benefits under the annuity contract.

c. Financial Industry Regulatory Authority

The Securities and Exchange Commission (SEC) has approved the Financial Industry Regulatory Authority’s (FINRA) new rules relating to variable annuity suitability and the supervision of variable annuity sales. FINRA includes the organization formerly known as the National Association of Securities Dealers (NASD). In July 2007, the SEC approved the formation of a new Self-Regulatory Organization (SRO) to be a successor to NASD. The NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange were then consolidated into the Financial Industry Regulatory Authority (FINRA).

d. Equity-Based

Equity-based guarantees refer to applying equity indexes as an option in the valuation of the accounts. Some form of guarantee as to the minimum value is made by the insurer regarding the value of the portfolio held by the annuitant in the variable accounts. Such products are relatively new. The insurance industry has had limited experience in setting and implementing reserves for products containing equity-based guarantees. Furthermore, limited data on policyholder behavior makes it difficult for actuaries to develop methodologies for price and evaluate these products."

e. Risk-Based

This feature refers to interest rate risk. An interest rate guarantee based on bond or interest rate indexing is designed to guarantee the minimum value of the variable accounts in the variable annuity. Inflation, which is uncertain when the annuity is purchased, can reduce the real value of the annuity payout. The absence of markets for purchasing power-adjusted annuities has been pointed out as one of the important rationales for government-provided retirement income programs[3]. The introduction of Treasury securities which guarantee returns after inflation may lead to changes in this situation, and in particular, may facilitate the introduction of purchasing-power-adjusted annuities by some insurance companies.

2. Charges and Fees

The charges and fees under a variable annuity are different from those found in fixed annuities. This comes from the fact that variable annuities are subject to a greater degree of regulation because variable annuities are considered to be securities. The prospective purchaser of a variable annuity must be given a prospectus. Also, agents who sell these products must maintain a Securities and Exchange Commission license to sell securities, in addition to the state-issued license. Fees commonly charged to holders of variable annuities include;

Companies can charge a fee for each variable investment account to cover the extra management expenses associated with the particular account.

A mortality expense, generally 1%, is deducted proportionately from each of the variable accounts as well.

There can be a fee for switching between accounts or funds offered by the variable annuity. Annuity holders can transfer funds from the guaranteed account to (or between) variable accounts. A certain minimum number of such transfers might be gratis, after which fees apply. The issuer can also regulate timing or frequency of jumps between accounts.

3. Dollar Cost Averaging

This is a system of buying securities on a regular basis with a fixed dollar amount at regular intervals. Dollar cost averaging helps eliminate the worry of catching the market at the right time. With dollar cost averaging, money is invested gradually, at regular intervals, into professionally managed portfolios. This allows the policyholder to take advantage of market highs and lows, buying more shares when the price is low and fewer shares when the price is high. A key benefit is that over time, the average per-unit cost will normally be lower than either the high or the average price.

[3] “A Framework for Social Security Analysis,” Peter Diamond *Journal of Public Economics*, vol. 8, no. 3 (1977), pp. 275-298.

Here is a simple example to illustrate how dollar cost averaging works. A person consistently invests $100 each month for three months. The investment chosen initially costs $10 per share. In the first month, this means 10 shares are bought. Then the next month, the market drops. This is not necessarily bad news. Even though the shares purchased last month for $10 are now only worth $8, one needs to remember that consistent $100 investments per month are being made. Because the price has dropped, the monthly $100 now buys 12.5 shares instead of 10.

4. Death Benefit Guarantees

For variable annuities, the death benefit shall be at least equal to the cash surrender benefit. The cash surrender benefits are not to be less than the present value of that portion of the maturity value of the paid-up annuity benefit which would be provided under the contract at maturity arising from considerations paid prior to the time of cash surrender, reduced by prior withdrawals or partial surrenders of the contract. The present value is calculated on the basis of an interest rate not more than 1 percent higher than the interest rate specified in the contract for accumulating the net considerations to determine the maturity value, decreased by indebtedness including interest, and increased by any existing additional amounts credited by the company to the contract. Cash surrender benefit cannot be less than the minimum nonforfeiture amount.

5. Living Benefit Guarantees

Insurance companies offer living benefits that give principal protection throughout the entire term of a variable annuity contract. The living benefits come in several forms:

- The guaranteed minimum income benefit, which guarantees a minimum level of income at annuitization
- The guaranteed minimum accumulation benefit, which guarantees a minimum account value at some point in the future
- The guaranteed minimum withdrawal benefit, which guarantees a minimum stream of income, equal to return of the variable annuity owner’s principal, if withdrawn within specified limits over time.

E. Contract Provisions Common to Indexed Annuities

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

Other features of equity index annuity contracts vary from product to product.
Premium Payments- The majority of products on the market are single premium deferred annuities; with the purchaser making one premium payment that is accumulated for some period prior to payout. Some insurers offer flexible premium deferred annuities, permitting multiple premium payments in amounts determined by the purchaser, and immediate annuities, providing for immediate commencement of the payout
Floor Guarantee- The guaranteed minimum return for a single premium product

typically is 90% of premium accumulated at a minimum interest rate. Accumulation was at a 3% annual rate of interest, but as discussed in IV B 5 “Minimum Guaranteed Interest Rate” this is going to eventually change to a floating rate.

1. Primary Interest Crediting Strategies

The index-based return depends on the particular combination of indexing features specified in the contract. The return of equity index annuities is typically based on the S&P 500 Index, but other domestic and international indices are also used. Some products permit the contract owner to select one or more indices from a specified group of indices. Index growth generally is computed without regard to dividends. There are several methods for determining the change in the relevant index over the period of the contract. The most common indexing features are described below

The "point-to-point" method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term.

The "high water mark" or "look-back" method compares the highest index level reached on specified dates throughout the term of the contract (e.g., contract anniversaries) to the index level at the beginning of the contract term.

The "annual reset," "cliquet," or "lock-in" method compares the index level at the end of each contract year to the index level at the beginning of that year, with the gain for each year "locked in" even if the index declines in the following year. Averaging techniques may be used with these formulas to dampen the volatility of index changes. For example, in the point-to-point method, the ending index value could be computed by averaging index values on each of the final 90 days of the contract term.

a. Monthly Averaging

This method uses the monthly closing market levels to determine the index level at the end of the contract term. The interest rate provides a return equal to the monthly average S&P of the previous year, times a participation rate which is then adjusted, as dictated under the contract, to be not less than zero- or other floor- nor higher than the CAP or maximum rate (say 14%). Suppose in year 1, the S&P goes up 20%- the client would get not 14% but about half that due to averaging. In the second year, the S&P did a -10%, but the client would just show no return at all due to the zero floor. In year 3, the S&P went up 20%- the client would get about 7%.

b. Point to Point

The point-to-point design credits interest based on the difference between the index value at the beginning and end of a period of at least one year. The change in the index is a "price change only" measure and does not reflect dividends. For example, the S&P 500 Index is at 900 and at the end of the crediting period the index result is 1,100. A gain of 22 percent is realized. The point-to-point design can be annual with an annual reset, or over a longer period of time, also known as a term point-to-point, that normally ranges from 7 to 12 years without a reset. The point-to-point term method works best in upward-trending markets over time, whereas the point-to-point with annual reset tends to work best in uncertain and volatile markets.

i. Annual

The annual point-to-point method calculates the interest return every contract year. It eventually combines these returns to arrive at the total return for the contract term. This method resets the starting point for the calculation each year on the contract anniversary and allows the owner to take advantage of economic upswing after a period of market loss or correction.

ii. Long-Term

The long-term point-to-point method compares the level of the index at two discrete points in time, such as the beginning and ending dates of the contract term in the point-to-point method, the ending index value could be computed by averaging index values on each of the final 90 days of the contract term. An example is 7 year, point-to-point, based on the S&P 500, using 6 month index averaging, with 80% participation, and a guaranty of 100% accumulating at 3%. Point-to-point methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the end of the term. Long term averaging may be used at the end of a multi-year point-to-point benefit determination, that is, when the index benefit is determined solely upon the change in the index from the beginning of the index term period to the end of the index term period, which could be up to ten years. Such averaging might be over a period of 2 to 24 months and commonly might use the average of monthly indices, Index-based interest is credited to the contract value either when it is calculated or at the end of the term. Interest in point-to-point contracts invariably is credited at the end of the term because its amount is unknown until then.

c. High Water Mark

This method of calculating the value of the index uses a fixed starting point to begin the computation. It does not reset the starting point of the index calculation periodically as other indexing methods might do. The annuity holder with this type indexing will only see positive interest appreciation when index levels are above the index point at the beginning. High water methods credit interest as a portion of the percentage growth in the underlying index from the beginning of the term to the highest value the index has achieved at specified measurement points up to the end of the term. Typically, these measurement points are the anniversaries in the contract, but they could occur with greater frequency. Each of these measurement points could use some averaging technique.

d. Annual Resets

This type of annuity calculation is also known as the ‘ratchet’ method. The annual reset design credit index-based interest to the current contract value on an annual basis. Most ratchets operate annually; however, less frequent application is possible.

e. Combination Methods

The following variations of the design are used for the reset/ratchet method. The discussion above pointed out other combinations.

Method of accumulation- A compound ratchet applies the index-based interest rate to the current contract value at the time of the crediting. A simple ratchet applies the index-based interest rate to the premium minus cumulative withdrawals at the time of the crediting.

Length of guaranty of index change recognition-.The current participation rate, spread charge, or cap can be guarantied for the entire term, only for the current interest crediting period, or for some intermediate period. If the guaranty is only for the current interest crediting period, a lesser guaranty commonly is provided for the balance of the term and subsequent terms.

Annual averaging of index values within each year- This is used for ratchet designs to reduce the volatility in the interest credited to the contract. Another result is that a nominally higher portion of the calculated index increase rate is reflected in the interest rate. Methods used are daily averaging, monthly averaging, and quarterly averaging. These methods reflect on average half to slightly more than half of the annual index increase percentage; however, the portion will vary considerably from year to year depending upon the profile of the index volatility during the year. Ratchet Payment guaranties provide an increase over the most recent annuity payment if equity index based interest exceeds the assumed interest rate. This is analogous to a ratchet benefit in a deferred equity indexed annuity.

2. Spreads

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

3. Cap Rates

The cap rate operates to limit the amount of growth in the applicable market index that will be credited to the equity-indexed annuity. The cap is an upper limit on the amount of growth that can be passed on the annuity holder. The cap rate is expressed as a percentage. For example, an equity-indexed annuity with a participation rate of 100% might provide that a maximum of 12% of the gain in the index will be passed on to the value of the contract.

F. Available Riders

A rider is a written agreement attached to an insurance policy or annuity contract that limits or expands the policy's terms or coverage. Riders may increase the premium paid to the insurance company. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs.

1. Life Insurance Rider

A life insurance rider would be just that. An increased, separate, amount would be paid for life insurance protection in some amount. Such insurance could feature an accelerated benefit option that allows for the early payment of some portion of the policy's face amount should the insured suffer from a terminal illness or injury. Any direct coupling of whole life insurance and an annuity contract would seem to fly in the face of the Supreme Court's decision in *Helvering v. Le Gierse*[4], where just such a coupling was decided to be a hedging or investment transaction, not insurance.

Tax-qualified term life- Tem life as a part of an annuity contract is considered incidental life insurance. If all of a person's 403(b) accounts invest only in mutual funds, then he or she has no incidental life insurance. If someone has an annuity contract, a portion of the cost of that contract may be for incidental life insurance. If so, the cost of the insurance is taxable to the individual in the year contributed and is considered part of the basis when distributed. The employer will include the cost of a person's insurance as taxable wages in box 1 of Form W-2. Not all annuity contracts include life insurance. If it does, the plan participant will need to figure the cost of life insurance each year the policy is in effect.

Figuring the cost of incidental life insurance. If it is determined that part of the cost of an annuity contract is for an incidental life insurance premium, he or she will need to determine the amount of the premium and subtract it from the includible compensation. To determine the amount of the life insurance premiums the individual will need to know the following information.

- The value of the life insurance contract, which is the amount payable upon the named insured's death.
- The cash value of the life insurance contract at the end of the tax year.
- The taxpayer's age on his or her birthday nearest the beginning of the policy year.
- The current life insurance protection under an ordinary retirement income life insurance policy, which is the amount payable upon death minus the cash value of the contract at the end of the year

2. Long-Term Care Benefits Rider

Annuities can have riders that meet a future need. An annuity with a long-term care rider that will pay for nursing home costs is an example of a rider that addresses a future concern. A long-term care rider fill the bill among consumers because it provides for two needs; provides the prospect of a stable retirement income while protecting against the financial risk associated with chronic long-term health problems. Many LTC riders are similarly constructed, providing coverage for catastrophic illnesses that require home health care, like an in-home nurse or aide, or long-term hospitalization, or a nursing home stay.

a. Terms of Riders

These riders are designed to provide benefits without cutting into the monthly payments received from an annuity. Thus, a long-term care rider on an annuity can provide great coverage in the event of an accident or unplanned illness. As with any added benefit,

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[4] (1941) 312 U.S. 53

however, the cost can be a drawback. There can be minimum deposits required, sometimes ranging from $30,000 to $50,000 for the initial product purchase. Many annuities with long-term care riders require that the annuity be held for a certain term, such as 7-10 years. It is important that careful attention is given to how the contract defines "catastrophic" or "chronic" illness.

b. Difference Between Crisis Waivers & Long-Term Care Riders

Strictly speaking, a waiver is an intentional and voluntary surrender of some known right, which generally may either result from an express agreement or can be inferred from circumstances. It is the relinquishment of a known right that may result from either the affirmative acts of the insurer or its authorized agents, or from the insurer's nonaction, with knowledge of the applicable facts. In this case, the insured waives ownership rights to the policy in exchange for consideration (the early payment of cash).

Concerning endorsements or riders, these are written modifications of an insurance policy that changes the original, often standardized, contract of insurance. Endorsements may broaden or narrow the original policy language. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs. At least one form must be added to the insuring agreement and the terms and conditions in order to structure a complete contract. In this case, the addition is the long-term care coverage.

3. Loan Provisions

It is difficult for many people to forecast their financial needs accurately for more than five to seven years in the future. Indexed annuity products impose surrender charges that start out as high as 15 to 20 percent and gradually decline over a surrender-charge period that is rarely less than seven years. Moreover, surrender during this period might also trigger forfeiture of premium bonuses and interest credits. To provide some liquidity and avoid the effects of early surrender, many indexed annuities provide for "free withdrawals" (up to an overall maximum) and these contracts also typically contain loan provisions that allow owners additional penalty-free access to accumulation values. If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. This treatment also applies to any loan under a contract purchased under a retirement plan, and to the value of any part of the interest in the plan or contract that an individual pledges or assigns (or agrees to pledge or assign). It applies to loans from both qualified and nonqualified plans, including commercial annuity contracts purchased directly from the issuer.

IV. The Application of Income Taxation of Qualified & Non-Qualified Annuities

The U.S. individual annuity market is one component of the broader market for life insurance products. The American Council on Life Insurance (ACLI) (2008) reports that in 2008, premiums paid into annuities totaled $355 billion. By comparison, premiums for group annuities totaled $119 billion.

A. Qualified vs. Non-qualified

• A **qualified employee plan** is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and rollover distributions, and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify).
• A **nonqualified employee plan** is an employer's plan that does not meet Internal Revenue Code requirements for qualified employee plans. It does not qualify for most of the tax benefits of a qualified plan.

1. Defined Benefit

A traditional defined benefit plan is a plan in which the benefit on retirement is determined by a set formula, rather than depending on investment returns. It is any pension plan that is <u>not</u> a defined contribution plan. A traditional pension plan that *defines a benefit* for an employee upon that employee's retirement is a defined benefit plan. So, a plan that meets IRC requirements for qualified tax deductions. Nonqualified defined benefit plans are a form of deferred compensation, an example of which is the Supplemental Executive Retirement Plan (SERP).

Unlike a qualified plan, which is typically viewed as an agreement between an employer and a group of employees, a nonqualified plan is viewed as a collection of agreements between the employer and each individual employee. As a result, a violation of the terms of a nonqualified plan impacts only those participants affected by the violation, unlike a qualified plan where a violation of the plan’s terms with respect to just one employee can negatively affect all plan participants.

2. Defined Contribution

In a defined contribution plan, contributions are paid into an individual account for each member. The contributions are invested, for example in the stock market, and the returns on the investment (which may be positive or negative) are credited to the individual's account. On retirement, the member's account is used to provide retirement benefits, sometimes through the purchase of an annuity which then provides a regular income. Defined contribution plans are now the dominant form of plan in the private sector. The number of defined benefit plans in the US has been steadily declining, as more and more employers see pension contributions as a large expense avoidable by disbanding the defined benefit plan and instead offering a defined contribution plan.

As with defined benefit, a qualified plan is one that has IRS approval while a nonqualified plan does not.

B. Differences Between Qualified and Non-qualified

The tax treatment of annuities is an attractive feature that has added to their growth. The income on assets held in a deferred annuity account is not taxed until the payout phase, which can be many years after the income accrues. Annuities therefore afford and opportunity for asset accumulation at the pre-tax rate of return.

People planning for retirement may purchase annuities with pre-tax or after-tax dollars. As with qualified pension plans, annuities that are qualified (part of a qualified retirement plan) may be purchased with pre-tax dollars; nonqualified annuities are purchased with after-tax dollars.

Between the time the annuity is purchased and the time the contract owner receives payouts, no taxes are due on the dividends, capital gains, or interest earned by the assets in the annuity portfolio. When payouts are received, taxes are due on the difference between the annuity payouts and the annuitant's policy basis. The key tax principle is the derivation of an *exclusion ratio,* an estimate of the ratio of the annuitant's investment in the contract to the total expected payouts on the contract. The exclusion ratio is multiplied by the annuity payout in each period to determine the part of the payout that can be excluded from taxable income. Other chapters address this topic in detail.

Contrasting the tax treatment of annuities and mutual fund investments is helpful. Mutual fund investors pay taxes when their fund receives dividends or realizes capital gains. They are liable for both dividend and capital gains taxes even in periods when they do not sell their shares in the fund; when they sell their mutual food shares, they may also be liable for capital gains taxes or eligible for credit for capital losses. Annuity contract owners, in contrast, do not pay any taxes during the accumulation phase of their annuity, although they are liable for a 10 percent early withdrawal penalty and subject to income tax (see above). The annuity provider receives dividends and capital gains, but the annuitant only faces tax liability when payouts from the annuity policy are received. The liquidity of annuities is limited by the fact that the loan, pledge, or assignment of an annuity is treated as a taxable event.

All annuity payouts are taxed as ordinary income, whereas part of the return to mutual fund investments may be taxed at capital gains tax rates, which are lower than ordinary income tax rates for many taxpayers. At death, mutual fund investments are eligible for a step-up in basis and need not be liquidated. Annuities must be liquidated at death and the proceeds must be distributed and subjected to tax. The opportunity to defer taxes on the investment income from assets held in annuities is a powerful tool for building asset balances. Consider, for example, a 35-year-old considering various saving options to fund retirement income, with retirement beginning at age 65. Assume further that this individual plans to invest in an asset with an expected return of 7 percent per year and that investment income faces a marginal tax rate of 28 percent.

C. Payment of Premiums

For a non-qualified annuity, premiums paid into an annuity are not deductible. As a result, there is no current tax savings. Certain types of annuities may be deductible from

income tax if certain requirements are met:
Individual Retirement Annuity- These contributions may be deducted by the owner if neither the husband nor wife participates in an employer provided retirement plan. Deductibility may still be allowable if either or both spouses participate in such a plan and their income meets certain limits.
Tax Sheltered Annuity- (often referred to as a "403(b) plan" or a "tax-deferred annuity plan") This is a retirement plan for employees of public schools and certain tax-exempt organizations. Generally, a TSA plan provides retirement benefits by purchasing annuity contracts for its participants.
Qualified Employee Plan- This is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and rollover distributions, and capital gain treatment or the 10-year tax option for lump-sum distributions (if participants qualify). Premiums for a tax-qualified plan are tax deductible. An annuity contract may be held by a trust for a qualified plan. A qualified annuity plan must generally satisfy the same requirements as any other qualified plan.

D. Partial Withdrawals

Withdrawals from annuities may be made during the accumulation period or during the liquidation period.

Withdrawal Prior to Liquidation- If the annuitant funds a deferred annuity with a series of single premium deposits, or with level premiums, there will be a growing accumulation of funds prior to liquidation. In general, there is no federal income tax on the investment income earned on this accumulation unless there are total or partial withdrawals prior to age 59½. If an annuity owner withdraws funds during the accumulation period, the withdrawal is treated as if it is interest income, and it is subject to taxation as ordinary income. However, if the withdrawal is greater than all the investment income earned, the difference is treated as a return of principal. For example, assume Joan has deposited $5,000 in annuity premiums. Assume investment income has increased the value of her account by $2,000 so its total value is $7,000. Assume she withdraws $2,500. In the year of withdrawal, she must report $2,000 as ordinary income. The $500 is considered a return of capital. Moreover, after 1986 a 10 percent penalty tax is applied to the entire $2,500 withdrawal. Thus, if Joan makes a withdrawal prior to age 59½, she will pay the 10% penalty tax plus any additional ordinary income tax applicable.

Withdrawals in Liquidation

When the annuitant receives rent payments during the liquidation phase, part of the rent arises from the return of principal, as was noted earlier in the chapter. This part of the return is exempt from the income tax. The amount of the rent attributed to the return of principal is determined by an *exclusion ratio.* The mathematics of the exclusion ratio is covered in the sections describing income tax treatment. As an example of the favorable tax treatment of annuity withdrawals, assume David has paid $70,000 for an annuity. Over his expected lifetime he is to receive $100,000 in annuity rental payments from the insurer. (This figure would be calculated using IRS annuity tables.) In this case, David may exclude 70 percent of each payment, paying taxes only on the remaining 30 percent. Thus, if David receives $6,000 from his annuity in 1987, he reports only (.3 x $6,000) or $1,800 as taxable income. If his taxes are at a 28 percent marginal rate, he pays only (.28 x $1,800) or $504 in taxes on $6,000 in cash flow. Moreover, if David lives an exceptionally long life and receives much more than $100,000 from his annuity, he can continue to exempt from taxes 70 percent of each annuity rental receipt.

E. Loans and Assignments

Amount not received as an annuity- If a loan is received under an annuity contract, the amount received is treated as an amount not received as an annuity and included in current income. This is true whether the amount is received directly under the contract from the insurer or indirectly from another source. Any assignment or pledge of an annuity contract used to obtain a loan from a third party is considered to be an amount not received as an annuity.

Loans Treated as Distributions- If a person borrows money from his or her retirement plan, the loan must be treated as a nonperiodic distribution from the plan unless it qualifies for the exception explained below. Further, it applies if a person renegotiates, extends, renews, or revises a loan that qualified for the exception below if the altered loan does not qualify. The taxable part may be subject to the additional tax on early distributions. It is not an eligible rollover distribution and does not qualify for the 10-year tax option.

Exception for qualified plan, 403(b) plan, and government plan loans. At least part of certain loans under a qualified employee plan, qualified employee annuity, tax-sheltered annuity (TSA) plan, or government plan is not treated as a distribution from the plan. This exception applies only to a loan that either:

- Is used to buy an individual’s main home, or
- Must be repaid within 5 years.

To qualify for this exception, the loan must require substantially level payments at least quarterly over the life of the loan. If a loan qualifies for this exception, it must be treated as a nonperiodic distribution only to the extent that the loan, when added to the outstanding balances of all the participant’s loans from all plans of the employer (and certain related employers) exceeds the lesser of:

1) $50,000, or
2) Half the present value (but not less than $10,000) of the nonforfeitable accrued benefit under the plan, determined without regard to any accumulated deductible employee contributions.

F. IRS Section 1035 Exchanges

Tax-free exchange-.No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

If a person transfers a full or partial interest in a tax-sheltered annuity that is not subject to restrictions on early distributions to another tax-sheltered annuity, the transfer qualifies for nonrecognition of gain or loss.

If the annuitant exchanges an annuity contract issued by a life insurance company that is subject to a rehabilitation, conservatorship, or similar state proceeding for an annuity contract issued by another life insurance company, the exchange qualifies for nonrecognition of gain or loss. The exchange is tax-free even if the new contract is funded by two or more payments from the old annuity contract. This also applies to an exchange of a life insurance contract for a life insurance, endowment, or annuity contract.

In general, a transfer or exchange in which a person receives ***cash proceeds*** from the surrender of one contract and invests the cash in another contract does not qualify for nonrecognition of gain or loss. However, no gain or loss is recognized if the cash distribution is from an insurance company that is subject to a rehabilitation, conservatorship, insolvency, or similar state proceeding. For the nonrecognition rule to apply the taxpayer must also reinvest the proceeds in a single contract issued by another insurance company and the exchange of the contracts must otherwise qualify for nonrecognition. He or she must withdraw all the cash and reinvest it within 60 days. If the cash distribution is less than required for full settlement, the annuitant must assign all rights to any future distributions to the new issuer.

G. Gift of an Annuity

For tax purposes, a gift occurs if property is transferred without full and adequate consideration. The transfer of ownership of an annuity contract is considered under the same standard. The new owner of the contract must recognize ordinary income to the extent of the excess of the contract's cash surrender value over the investment in the contract at the time of the transfer. If a nonqualifed annuity contract is not transferred and the gift consists only of annuity payments, the owner of the contract generally will remain taxable on the income from the annuity payments and may have to pay the gift tax on same. If transfer of the contract is made to a spouse or former spouse subject to a divorce, no gift is made. If the gift is an interest in a joint and survivor annuity where only the plan participant and spouse have the right to receive payments, the gift will generally be treated as qualifying for the unlimited marital deduction.

H. Sale of an Annuity by Owner

When a nonqualified annuity contract is sold a gain or loss is recognized. The seller considers any gain ordinary income. The new owner's investment in the contract equals the consideration paid to acquire the contract plus the value of premiums paid after the transfer. Subtracted from this total is any amount received by the new owner before the annuity starting date that was excluded from income.

I. Death of an Annuity Owner

The minimum values of any death benefit available as specified in the appropriate sections of the Insurance Code shall be based on minimum nonforfeiture amounts. It is a matter of public policy that tax deferral treatment of annuities be limited. Annuities are to be used for retirement purposes and their use to achieve tax deferral beyond that time is discouraged by tax policy. There are two rules that affect annuity contracts in the event of death: The Death of the Holder Rule states that upon the death of a holder, death benefits of the annuity must and will be paid out. The "holder" is synonymous with the taxpayer/owner in any contract. In the case of a non-natural trust-owner, the annuitant is considered the owner, but only for death distributions. The Spousal continuation Rule [IRC 72(s)] states that the deceased owner's surviving spouse can become the contract owner. The surviving spouse can then continue the contract throughout his or her lifetime and is not forced to take a distribution. However, not all insurance annuity contracts offer the spousal continuation provision. If anyone else is named as a primary beneficiary along with the spouse, the option of the surviving spouse becoming the contract owner is usually lost. In cases where a child and spouse are named as primary beneficiaries, some companies will allow spousal continuation but only on the spouse's remaining portion of the contract. The IRC states only that the beneficiary be a spouse; however, some contracts specify that the spousal election letter will only be sent out if the surviving spouse is the "sole" beneficiary, which is a narrower interpretation of IRC.

1. Ordinary Income Tax Adjustment

If annuity funds are disbursed during the accumulation period, the withdrawal is treated as if it is interest income, and it is subject to taxation as ordinary income. However, if the withdrawal is greater than all the investment income earned, the difference is treated as a return of principal. For example, assume Joan has deposited $5,000 in annuity premiums. Assume investment income has increased the value of her account by $2,000 so its total value is $7,000. Joan meets an untimely death. For the year of death her estate must report $2,000 as ordinary income. The $5000 is considered a return of capital.

J. Death of Annuitant

If the annuitant and owner are the same person, when the annuitant dies so does the owner. The annuity is subject to distribution requirements as detailed elsewhere in the book.

1. Ordinary Income Tax Adjustment

When the annuitant is someone else, and that person dies before the deferred annuity matures, the amount payable at his or her death is taxable as ordinary income to the beneficiary to the extent that payment exceeds principal paid in to the annuity contract. It is not considered in the same light as life insurance proceeds. If the beneficiary elects to receive the benefits in an installment option or as a life income, the regular annuity income rules (Simplified Method or General Rule) apply.

K. Annuity Benefits Distribution

This section explains how the periodic payments received from a pension or annuity plan are taxed. Periodic payments are amounts paid at regular intervals (such as weekly, monthly, or yearly) for a period of time greater than one year (such as for 15 years or for life). These payments are also known as ***amounts received as an annuity.*** In general, an individual can recover the cost of their pension or annuity tax free over the period he or she is to receive the payments. The amount of each payment that is more than the part that represents cost is taxable.

1. Exclusion Ratio

Between the time the annuity is purchased and the time the contract owner receives payouts, no taxes are due on the dividends, capital gains, or interest earned by the assets in the annuity portfolio. When payouts are received, taxes are due on the difference between the annuity payouts and the annuitant's policy basis. The key tax principle is the derivation of an *exclusion ratio,* an estimate of the ratio of the annuitant's investment in the contract to the total expected payouts on the contract. The exclusion ratio is multiplied by the annuity payout in each period to determine the part of the payout that can be excluded from taxable income.

2. Tax-deferred Compounding

a. Computing Taxable vs. Tax-Deferred vs. Tax-Free Returns

The taxpayer figures the tax-free part of the payment using one of the following methods.

- ***Simplified Method**.* A person generally must use this method if his or her annuity is paid under a qualified plan (a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity plan or contract). He or she cannot use this method if their annuity is paid under a nonqualified plan.
- ***General Rule**.* One must use this method if his or her annuity is paid under a nonqualified plan. Generally, a taxpayer cannot use this method if the annuity is paid under a qualified plan.

Simplified Method

Under the Simplified Method, a person figures the tax-free part of each annuity payment by dividing the annuity cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. A taxpayer must use the Simplified Method if his or her annuity starting date is after November 18, 1996, and he or she meets *both* of the following conditions.

1) An individual receives a pension or annuity payments from any of the following qualified plans.
    a) A qualified employee plan.
    b) A qualified employee annuity.
    c) A tax-sheltered annuity (TSA) plan or contract.
2) On their annuity starting date, at least one of the following conditions applies;
    a) The person is under age 75.
    b) The person is entitled to fewer than 5 years of guaranteed payments.

Who cannot use the Simplified Method. An individual cannot use the Simplified Method if he or she received a pension or annuity from a nonqualified plan or otherwise do not meet the conditions described in the preceding discussion. See *General Rule,* later.

How to use it- The Simplified Method worksheet can be copied and used to figure a person's taxable annuity for the current year. The taxpayer should keep the completed worksheet; it will help figure the taxable annuity for the next year. To complete line 3 of the worksheet, the taxpayer must determine the total number of expected monthly payments for the annuity. How a person does this depends on whether the annuity is for a single life, multiple lives, or a fixed period. For this purpose, treat an annuity that is payable over the life of an annuitant as payable for that annuitant's life even if the annuity has a fixed period feature or also provides a temporary annuity payable to the annuitant's child under age 25. The taxpayer does not need to complete line 3 of the worksheet or make the computation on line 4 if he or she received annuity payments the previous year and used that year's worksheet to figure the taxable annuity. Instead, enter the amount from line 4 of the previous year's worksheet on line 4 of the current year's worksheet.

Single life annuity- If an annuity is payable for one person's life alone, use Table 1 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for the age of the subject individual on the annuity starting date. This number will differ depending on whether the annuity starting date is before November 19, 1996, or after November 18, 1996.

Multiple lives annuity*.* If the annuity is payable for the lives of more than one annuitant, use Table 2 at the bottom of the worksheet to determine the total number of expected monthly payments. Enter on line 3 the number shown for the annuitants' combined ages on the annuity starting date. For an annuity payable to the primary annuitant and to more than one survivor annuitant, combine the annuitant's age and the age of the youngest survivor annuitant. For an annuity that has no primary annuitant and is payable to an individual and others as survivor annuitants, combine the ages of the oldest and youngest annuitants. Do not treat as a survivor annuitant anyone whose entitlement to payments depends on an event other than the primary annuitant's death. However, *if the annuity starting date is before 199*8, do not use Table 2 and do not combine the annuitants' ages. Instead, the taxpayer must use Table 1 at the bottom of the worksheet and enter on line 3 the number shown for the primary annuitant's age on the annuity starting date. This number will differ depending on whether the annuity starting date is before November 19, 1996, or after November 18, 1996.

Fixed period annuity- If the annuity does not depend on anyone's life expectancy, the total number of expected monthly payments to enter on line 3 of the worksheet is the number of monthly annuity payments under the contract.

Example. Bill Kirkland, age 65, began receiving retirement benefits in 2002 under a joint and survivor annuity. Bill's annuity starting date is January 1, 2002. The benefits are to be paid for the joint lives of Bill and his wife, Kathy, age 65. Bill had contributed $31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death. Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages and Table 2 at the bottom of the worksheet in completing line 3 of the worksheet. His completed worksheet follows.

Simplified Method Worksheet		
1. Enter the total pension or annuity payments received this year. Also, add this amount to the total for Form 1040, line 16a, or Form 1040A, line 12a		$14,400
2. Enter your cost in the plan (contract) at annuity starting date Note: *If your annuity starting date was before this year and you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year's worksheet on line 4 below. Otherwise, go to line 3.*		31,000
3. Enter the appropriate number from Table 1 below. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below		310
4. Divide line 2 by line 3		100
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6		1200
6. Enter any amounts previously recovered tax free in years after 1986		-0-
7. Subtract line 6 from line 2		31,000
8. Enter the lesser of line 5 or line 7		1,200
9. **Taxable amount for year.** Subtract line 8 from line 1. Enter the result, but not less than zero. Also add this amount to the total for Form 1040, line 16b, or Form 1040A, line 12b Note: *If your Form 1099R shows a larger taxable amount, use the amount on line 9 instead.*		$13,200
10. Add lines 6 and 8		1,200
11. Balance of cost to be recovered. Subtract line 10 from line 2		$29,800

Table 1 for Line 3 Above
AND your annuity starting date was

If the age at annuity starting date was. . .	before November 19, 1996, enter on line 3	after November 18, 1996, enter on line 3
55 or under	300	360
56–60	260	310
61–65	240	260
66–70	170	210
71 or older	120	160

Table 2 for Line 3 Above

Combined ages at annuity starting date	Enter on line 3
110 and under	410
111–120	360
121–130	310
131–140	260
141 and over	210

Bill's tax-free monthly amount is $100 ($31,000 X 310 as shown on line 4 of the worksheet). Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income. If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die. This deduction is not subject to the 2%-of-adjusted-gross-income limit.

General Rule

The IRS provides life expectancy tables to assist the taxpayer in computing the minimum required distribution amount. In general one can recover the net cost of the annuity tax-free over the period that he or she is to receive the payments. The amount of each payment that is more than the part that represents the net cost is taxable. Under the General Rule, the part of each annuity payment that represents net cost is in the same proportion that the investment in the contract is to the annuitant's expected return.

Expected Return

The expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. The following discussions explain how to figure the expected return with each type of annuity. A person's age, for purposes of figuring the expected return, is the age at the birthday nearest to the annuity starting date.

Fixed period annuity- If a person expects to receive annuity payments for a fixed number of years, without regard to his or her life expectancy, the expected return must be figured based on that fixed number of years. It is the total amount to be received by the annuitant and other eligible annuitants beginning at the annuity starting date. Specific periodic payments are expected to be received for a definite period of time, such as a fixed number of months (but not less than 13). To figure the expected return, one should multiply the fixed number of months for which payments are to be made by the amount of the payment specified for each period.
Single life annuity- If annuity payments are to be received for the rest of the annuitant's life, find the expected return as follows. The person must multiply the amount of the annual payment by a multiple based on his or her life expectancy as of the annuity starting date. These multiples are set out in actuarial Table I, a portion of which is displayed at the end of this section. **Actuarial Tables I-VIII are available on line at the IRS website**, www.IRS.gov. These multiples may need adjustment if the payments are made quarterly, semiannually, or annually.

Example. Henry Martin bought an annuity contract that will give him an annuity of $500 a month for his life. If at the annuity starting date Henry's nearest birthday is 66, the expected return is figured as follows:

Annual payment ($500 × 12 months)	$6,000
Multiple shown in Table V, age 66	× 19.2
Expected return	$115,200

If the payments were to be made to Henry quarterly and the first payment was made one full month after the annuity starting date, Henry would adjust the 19.2 multiple by +.1. His expected return would then be $115,800 ($6,000 × 19.3).

Computation Under General Rule

Under the General Rule, the taxpayer figures the taxable part of the annuity by using the following steps:

Step 1. The amount of the investment in the contract should be figured, including any adjustments for the refund feature and the death benefit exclusion. This exclusion from income does not apply if someone is the beneficiary of an employee who died after August 20, 1996.

Step 2. Figure the expected return.

Step 3. Divide Step 1 by Step 2 and round to three decimal places. This will give the exclusion percentage.

Step 4. Multiply the exclusion percentage by the first regular periodic payment. The result is the tax-free part of each pension or annuity payment. The tax-free part remains the same even if the total payment increases or if the taxpayer outlives the life expectancy factor used. If the annuity starting date is after 1986, the total amount of annuity income that is tax free over the years cannot exceed the net cost. Each annuitant applies the same exclusion percentage to his or her initial payment called for in the contract.

Step 5. Multiply the tax-free part of each payment (step 4) by the number of payments received during the year. This will give the tax-free part of the total payment for the year. In the first year of the annuity, the individual’s first payment or part of the first payment may be for a fraction of the payment period. This fractional amount is multiplied by the exclusion percentage to get the tax-free part.

Step 6. Subtract the tax-free part from the total payment which has been received. The rest is the taxable part of the pension or annuity.

Example 1. You purchased an annuity with an investment in the contract of $10,800. Under its terms, the annuity will pay you $100 a month for life. The multiple for your age (age 65) is 20.0 as shown in Table V. Your expected return is $24,000 (20 × 12 × $100). Your cost of $10,800, divided by your expected return of $24,000, equals 45.0%. This is the percentage you will not have to include in income. Each year, until your net cost is recovered, $540 (45% of $1,200) will be tax free and you will include $660 ($1,200 - $540) in your income. If you had received only six payments of $100 ($600) during the year, your exclusion would have been $270 (45% of $100 × 6 payments).

Example 2. Gerald Morris bought a joint and survivor annuity. Gerald's investment in the contract is $62,712 and the expected return is $121,200. The exclusion percentage is 51.7% ($62,712 ÷ $121,200). Gerald will receive $500 a month ($6,000 a year). Each year, until his net cost is recovered, $3,102 (51.7% of his total payments received of $6,000) will be tax free and $2,898 ($6,000 - $3,102) will be included in his income. If Gerald dies, his wife will receive $350 a month ($4,200 a year). If Gerald had not recovered all of his net cost before his death, his wife will use the same exclusion percentage (51.7%). Each year, until the entire net cost is recovered, his wife will receive $2,171.40 (51.7% of her payments received of $4,200) tax free. She will include $2,028.60 ($4,200 - $2,171.40) in her income tax return.

ACTUARIAL TABLES **(Only a portion is shown, go to www.IRS.gov for complete Tables I-VIII)**

Table I (One Life) applies to all ages. Tables II–IV apply to males ages 35 to 90 and females ages 40 to 95.

Table I.—Ordinary Life Annuities—One Life—Expected Return Multiples

Ages		Multiples	Ages		Multiples	Ages		Multiples
Male	Female		Male	Female		Male	Female	
6	11	65.0	41	46	33.0	76	81	9.1
7	12	64.1	42	47	32.1	77	82	8.7
8	13	63.2	43	48	31.2	78	83	8.3
9	14	62.3	44	49	30.4	79	84	7.8
10	15	61.4	45	50	29.6	80	85	7.5
11	16	60.4	46	51	28.7	81	86	7.1
12	17	59.5	47	52	27.9	82	87	6.7
13	18	58.6	48	53	27.1	83	88	6.3
14	19	57.7	49	54	26.3	84	89	6.0
15	20	56.7	50	55	25.5	85	90	5.7

b. Long-term Effect of Tax-Deferred vs. Other Investment Choices

Annuities offer tax-deferred growth of savings. The overarching characteristic of an annuity is that it is a vehicle for distributing savings with a tax-deferred growth factor. A common use for an immediate annuity might be to provide a pension income. In the U.S., the tax treatment of a non-qualified immediate annuity is that every payment is a combination of a return of principal (which part is not taxed) and income (which is taxed at ordinary income rates, not capital gain rates). As pointed out in other sections of this book, other investment opportunities may offer a higher rate of growth, but it comes with higher risk.

L. Tax Effect on Estate

To determine the effect on a beneficiary, living or dead, it must first be understood whether the owner includes the annuity in his or her estate. This depends on whether the annuity is in the accumulation or distribution phase. In the accumulation phase, whether payable to the annuity holder or a third party beneficiary, the death benefit is included in the gross estate. In the annuitization phase, estate tax status is dependent on the type and terms of the contract. A straight life annuity leaves no residual value, thus nothing is included in the estate. If a settlement option is involved that included some sort of survivor benefit, the status of the benefit can vary.

Estate Tax Treatment of Annuities- The balance of a guaranteed amount is paid to a beneficiary when an annuitant dies. When this occurs, the payment is not taxable as income until the investment in the contract has been received tax free. The amount received by the beneficiary is added to the tax free amounts received by the annuitant. Only the amount received that exceeds the total amounts paid in will be taxable.
The annuity owned by a decedent may be subject to federal estate tax when any residual value is passed on to a survivor or beneficiary. Section 2039 of the Internal Revenue Code addresses estate taxation of annuities. It provides for a premium payment test to be used to determine value. The following guidelines are used:

- If the decedent did not pay any of the premiums, nothing will be included in the estate.
- When the decedent paid the premiums, all of the remaining annuity payments or benefits are includable in the gross estate of the annuitant.
- If only part of the premiums was paid by the deceased, only that part of the subsequent payments or benefits is includable in the decedent's gross estate. The same ratio as the value of premiums paid relative to the total value of premiums paid on the contract will be the determining factor.

Annuity benefits payable to the estate will be included in the gross estate. Any other amounts in question will be determined using the guidelines above. When annuity payments terminate at or before the annuitant's death, then no amount will be ascribed to the gross estate of the decedent. A person may be entitled to a deduction for estate tax if he or she receives a joint and survivor annuity that was included in the decedent's estate. The part of the total estate tax that was based on the annuity can be deducted, provided that the decedent died after his or her annuity starting date. It should be deducted in equal amounts over the remaining life expectancy of the survivor.

M. Disclaimer

It is good policy to include disclaimers when advising about annuities. A disclaimer is generally any statement intended to specify or delimit the scope of rights and obligations that may be exercised and enforced by parties in a legally recognized relationship. It implies situations that involve some level of uncertainty, waiver, or risk.

1. If a life agent offers to sell to a client any life insurance or annuity product, the life agent shall advise the client or the client's agent in writing that the sale or liquidation of this product may have tax consequences.
2. The life agent shall disclose that the client may wish to consult independent legal counsel or financial advice before buying, selling or liquidating any assets being solicited or offered for sale.
3. This course is not intended to provide advice with issues surrounding income and estate taxation of annuities. If expert tax assistance is required, life agents shall advise client to consult with other professionals.

V. The Primary Uses of Annuities

A. What an Annuity Does

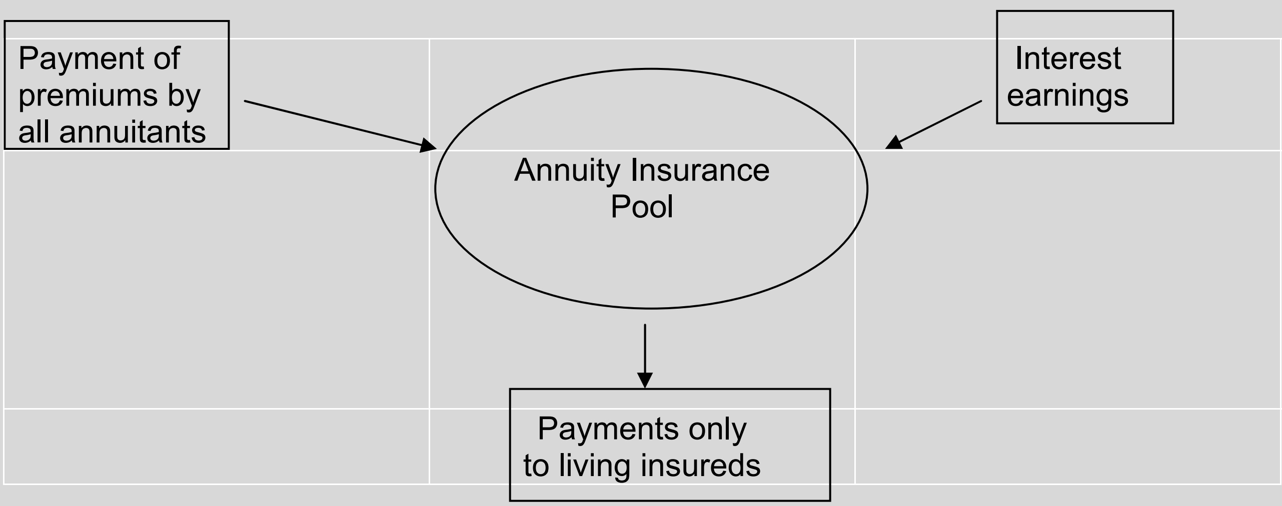
An annuity can be seen as a stream of regular payments. An annuity insurance policy is a contract in which the insurer promises the insured, called the annuitant, a regular series of payments, called rent. The basic insurance principles that underlie an annuity insurance operation are the same as those that underlie all insurance operations. That is, the insurance company combines many individuals exposed to the same peril. It uses the law of large numbers to predict in advance the payments it must make. Then it charges each insured a fair share of all losses. By charging a premium of all the individuals exposed to the peril, the insurance operation transfers money from all the people exposed to the peril to those who will experience the loss.

The "loss" insured against with an annuity is living a long time. This sounds like a loss that most people would not dislike. However, old age without money can be a tragedy. An annuity insurance operation transfers funds from those who die at a relatively early age to those who live to relatively old ages. That is, some annuitants will live to take out much more than they paid in as a premium. Other annuitants will not live long enough to take out as much as they paid in. Every annuitant pays a fair premium to enter the annuity insurance pool. In exchange for the premium, the annuitant obtains the right to receive regular payments from the insurance pool as long as he or she is alive. An insurance company earns interest on all the money in the pool. Therefore, the annuity payments received by an annuitant will come from three sources: (1) liquidation of the original premium payment, or principal, (2) interest earned on the principal, and (3) funds made available by the relatively early death of some annuitants

An annuity is defined as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and continue throughout a specified period of time or for the duration of a designated life or lives. Chart II A illustrates the types of annuities and their payment method.

. This concept is illustrated in Figure 2-1.

<u>FIGURE 2-1. The Annuity Insurance Operation</u>



It is interesting to note that the mortality table used by annuity insurers to predict the amount of payments they will make is not the same one used for life insurance calculations. People who purchase annuities live longer than do those who do not purchase annuities. While mortality tables used for life insurance calculations end at age 100, the 1983 individual annuity mortality table and Annuity 2000 mortality table continue to age 115. The reason for this is *adverse selection.*

Adverse selection in life insurance means that those people with a greater than average likelihood of premature death try to purchase life insurance at regular rates. Life insurers try to prevent adverse selection by requiring medical examinations in addition to other underwriting precautions. It is more difficult to prevent adverse selection by people purchasing annuities. Theoretically, an insurer could require a medical examination and then reject the "superhealthy" as "poor risks." However, this generally is not a sound approach to take with the public. Therefore, the insurer recognizes that people who purchase annuities are probably in above-average health. This explains why they use a mortality table that reflects this better than average mortality. Annuities offered by insurance companies are usually priced to cover operating costs and costs of adverse selection.

Concept of 'Retirement' Age

To appreciate the difficulty of giving up work and entering retirement, one must first understand the paradigm shift that has occurred since the contemporary concept of retirement began. Historically, workers worked until they couldn't work anymore. The age 65 metric is a relatively recent addition to the retirement requirement. As Germany consolidated into one nation and industrialized, this somewhat arbitrary age picked was chosen by German Chancellor Otto von Bismarck for one of the first retirement plans in the mid-1800s. What was the average life expectancy in the mid-1800s? It was in the mid-40s. So, in order to realize retirement benefits, workers had to outlive their life expectancy by approximately 50 percent. When the Social Security Act was created in the 1930s, life expectancy had jumped to about 62, according to the Social Security Administration. It was an actuarially flawless plan; the average person would not live long enough to realize any benefits from the program. It was designed to take care of those few people who, in effect, lived too long to work. With the economic expansion in full swing just a decade later in post-World War II America, there were tremendous inflationary pressures. Federal wage controls were instituted to prevent workers from being poached by other companies with higher wages. Employers needed a new value proposition to offer prospective employees: "If you put 20 years on the clock, I will pay you not to work here any longer." Thus, modern corporate pension plans came into being. It was a pretty safe bet most workers would not make it to retirement age anyway, and if they did, they'd only have a few years left to enjoy their retirement. The difference today is that Americans have much greater longevity. By the standards of yesterday, retirement benefits would not be offered in this day and age until around age 90.

B. Utilization of Annuities

The term "annuity," as used in financial theory, is most closely related to what is today called an *immediate annuity*. The overarching characteristic of the immediate annuity is that it is a vehicle for distributing savings with a tax-deferred growth factor. A common use for an immediate annuity might be to provide a pension income. In the U.S., the tax treatment of a non-qualified immediate annuity is that every payment is a combination of a return of principal (which part is not taxed) and income (which is taxed at ordinary income rates, not capital gain rates). Immediate annuities funded as an IRA do not have any tax advantages, but typically the distribution satisfies the IRS required minimum distribution requirement and may satisfy the required minimum distribution requirement for other IRA accounts of the owner (IRC Sec 1.401(a)(9)-6.). When a deferred annuity is annuitized, it works like an immediate annuity from that point on, but with a lower cost basis and thus more of the payment is taxed.

Phased Withdrawal vs. Fixed Payout

Financial advisers have developed standardized payout strategies to help people manage their money in their retirement years. Prominent among these are *phased withdrawal* plans offered by mutual funds including the “self-annuitization” or default rules encouraged under US tax law, and *fixed payout* annuities offered by insurers. To have enough for retirement, workers must first choose which payout strategy to employ for a wide range of risk aversions.

The annuitization option assures a lifelong consumption stream that cannot be outlived, but at the expense of a complete loss of liquidity. On the other hand, in self-annuitization, discretionary management and consumption from assets preserves flexibility, but with the distinct risk that a constant standard of living will not be maintainable. A retiree who decides to forego the life annuity and instead withdraw a fixed periodic amount from wealth will find it difficult to compete with the very high “mortality credits” at advanced ages.

The life annuity gives the retiree a constant income stream as long as he or she lives. When self-annuitizing, the retiree invests his or her money in an investment fund and periodically withdraws money to finance needs. This gives the retiree more flexibility in structuring his or her consumption stream, but exposes the retiree to individual longevity risk. Thus, on the one hand, the retiree may outlive his or her financial resources by living longer than expected and/or by poor mutual investment fund performance (shortfall risk). On the other hand, the retiree may be able to bequeath substantial wealth.

Dependent on asset allocation or annuity purchase age, it is possible to minimize but never to fully eliminate shortfall risk. In other words and this is not surprising there is no easy arbitrage possibility in the annuity market. From a retiree’s viewpoint, knowing the shortfall risk magnitude is not very helpful in making investment decisions. However, it is not easy to clearly see the entire chance and risk profile of the self-annuitization strategy, because information about the utility of the bequest may be necessary to evaluate the chances.

C. A Life Annuity

The simplest form of life annuity is a bond-like investment with longevity insurance protecting the retiree from outliving his or her resources, guaranteeing lifetime level payments to the annuitant. Insurers hedge these contracts by pooling the longevity risks across a group of annuity purchasers. Standard economic theory informs that life annuities will be valued by risk-averse retirees, inasmuch as these contracts provide a steady income for life and hence they protect the retiree against the risk of exhausting his or her assets. Economic theory tells us that the retiree maximizing a time separable utility function without a bequest motive would buy annuities with all his or her wealth, given a single risk-free asset and facing actuarially fair annuities. Yet available evidence from most countries indicates that very few retirees actually purchase annuities with their disposable wealth.

Efforts to explain this so-called “annuity puzzle” have noted some disadvantages of annuitization; for example, buyers lose liquidity because the assets usually cannot be recovered even to meet special needs. The presence of a bequest motive also reduces retiree desires to annuitize wealth. Other explanations for why people may be reluctant to buy annuities include high insurance company loadings; the ability to pool longevity risk within families; asymmetric mortality expectations between annuity buyers and sellers; and the existence of other annuitized resources such as Social Security or employer-sponsored pensions. In addition, annuities can appear relatively expensive depending on the interest rate environment, as compared to equity-based mutual fund investments. Also, many payout annuities sold by commercial insurers are fixed in nominal terms, so inflation erodes the value of the stream of payments. The annuity purchaser also misses out on gains in stock market performance.

Another reason people may not annuitize is that they believe they will do better by continuing to invest their retirement assets, making withdrawals periodically over their remaining lifetimes. Doing this is not so simple, however, as the retiree must select both an investment strategy- how much to invest in stocks and bonds- and a withdrawal rate, spelling out how much of their balance to spend per year. Financial advisors often recommend “rules of thumb,” for instance dividing the portfolio roughly 60% stocks/40 % bonds and a spending rule of 4-5% of the balance per year. Compared to buying a fixed life annuity, such an investment-linked phased withdrawal strategy has several advantages;

- It provides greater liquidity
- Participation in capital market returns
- Possibly higher consumption while alive
- The chance of bequeathing assets in the event of early death.

Phased Asset Withdrawal and Risk

Yet a phased withdrawal tactic also exposes the retiree to investment risk and it offers no longevity pooling, so the retiree could possibly outlive his or her assets before an uncertain date of death. Thus any withdrawal plan which includes some risky investments also requires the retiree to draw a fixed amount from the retirement account each period. This involves a strictly positive probability of hitting zero before the retiree dies. The risk of running out of money can be partially mitigated by linking the drawdown to the fund balance each period, though of course this will produce benefit fluctuations which might fall substantially below what the life annuity payment would have been. Besides, not many people want to expend the effort to become wealth accumulation wizards. Consider this paragraph;

> Prior studies have compared the pros and cons of specific phased withdrawal plans with life annuities that pay fixed benefits. For instance, some authors calculate the probability of running out of money before the retiree’s uncertain date of death, using assumptions about age, sex, capital market performance, and initial consumption-to-wealth ratios. These analyses also show how an optimal asset mix can be set to minimize the probability of zero income. Follow-on works extended this research by quantifying risk and return profiles of fixed versus variable withdrawal strategies using a shortfall framework. On the return side, that study quantified the expected present value of the bequest potential and the expected present value of benefit payments; conversely, it measured the risk as the timing, probability, and magnitude of a loss when it occurs, compared to a fixed annuity benchmark.

What is the likelihood of getting a prospective client to read or comprehend this, even without getting a handle on the implied math calculations?

Planning Characteristics

Comprehensive financial planning has taken on many characteristics over the past decade as a result of economic changes. Retirement planning is an uncertain avocation that the average working person gets to do but once. It calls for well thought out and decisive action. Too often people delay taking important actions because of external circumstances. An advantage of annuities is that none, part or all of a current paycheck can be socked away for retirement.

Before any retirement planning decisions are made, future retirees must first create clear objectives or outcomes. Knowing how to fulfill retirement intentions begins with knowing what the intentions are. People must go through a self guided, self-actuated discovery process as the foundation for creating wise decisions and producing confident results. The process allows people to take the uncertainty out of their future and to be more intentional with wealth. Workers must ask of themselves what is important to them; not only for them, but for their families as well. This conversation must be conscientiously and doggedly pursued with the man or woman in the mirror on a periodic basis. The agent is reminded that the purpose of these mental inquiries for the client is to encourage individuals to reflect upon what they value most and what they intend to achieve as far as retirement is concerned. After helping clients develop a more complete knowledge of the ideas and objectives that are central to their lives. As the Gallup survey point out, most people’s goals are simple; not to outlive their means and perhaps to be able to leave a legacy to their children. Annuities fill this bill.

U.S. workers face a number of risks in both accumulating and preserving pension benefits. Specifically, workers may not accumulate sufficient retirement income because they are not covered by a defined benefit or defined contribution pension plan. For example, according to national survey data, about half of the workforce was not covered by a pension plan in 2008. Furthermore, workers covered by defined contribution plans, in particular, risk making inadequate contributions or earning poor investment returns, while workers with traditional defined benefit plans risk future benefit losses due to a lack of portability if they change jobs. Preretirement benefit withdrawals (leakage), high fees, and the inappropriate drawdown of benefits in retirement also introduce risks related to preserving benefits, especially for workers with defined contribution plans.

Key Risks in Accumulating and Preserving Retirement Benefits

Workers’ career							Retirement
$ Accumulation $ $ $ $ $				**$$$$$ Preservation**			$Liquidation$
Lack of coverage	Insufficient contributions	Poor investment Returns		Lack of portability	Leakage	High fees	Inappropriate drawdown of benefits

Pension plans offered by private employers in the United States operate in a voluntary system with tax incentives for workers to participate in plans that employers offer. Employers may choose to offer different types of plans which fall into two broad categories: defined benefit and defined contribution. A defined benefit plan is generally financed by the employer and typically provides retirement benefits in the form of an annuity that provides a guaranteed monthly payment for life, the value of which is determined by a formula based on salary and years of service. Defined benefit plans offer benefits in the form of an annuity; however, a defined benefit plan may also provide workers the option of receiving their benefits as a lump sum distribution.

Defined benefit plans can include hybrid plans, such as cash balance plans. Cash balance plans are referred to as hybrid plans because legally they are defined benefit plans but contain certain features that resemble defined contribution plans. As with traditional defined benefit plans, employers that sponsor a cash balance plan make contributions to a pension trust fund that is invested on behalf of the employees in the plan. However, unlike traditional defined benefit plans that express retirement benefits as an annuity amount calculated using years of service and earnings, cash balance plans express benefits as a hypothetical individual account balance that is based on pay credits (percentage of salary or compensation) and interest credits, rather than an annuity.

In a defined contribution plan workers and/or employers make contributions into individual accounts set up for each participant. Most defined contribution plans allow participants to direct these contributions to mutual funds and other financial market investments to accumulate pension benefits, dependent on net investment returns, which will then be withdrawn during retirement. Over the last two decades, the number of defined benefit plans has declined substantially while the number of defined contribution plans has increased. In 2007, about half of private sector workers participated in employer-sponsored pension plans; 21 million had a defined benefit plan and more than 40 million had a defined contribution plan. Research suggests that retirement income from pension plans is likely to be inadequate for many workers in the United States. In recent years, a considerable number of defined benefit plans have been terminated or closed to new participants, which prevents workers from accruing further benefits in those plans in most cases. For those with defined contribution plans, data gathered before the recent financial crisis indicate that many workers have low balances.

One study found that in 2007, median combined balances in 401(k) plans and Individual Retirement Accounts (IRA) were only $78,000 for individuals aged 55 to 64.[5] In the period of 2007-2009, poor investment returns led to considerable losses in many workers' defined contribution plans, leaving them at an even greater risk for having inadequate savings for retirement.
In addition to pension plans, retirees depend on other sources of income in retirement. Social Security benefits provide the largest source of retirement benefits for most households. In 2006, Social Security benefits provided almost 37 percent of total income compared to 18 percent provided by pension income in households with someone aged 65 or older, excluding nonannuitized payments or lump-sum withdrawals. (Data reported by the Social Security Administration for pension income includes regular payments from IRAs, Keogh, or 401(k) plans. Nonregular (nonannuitized or lump-sum) withdrawals from IRA, Keogh, and 401(k) plans are not

[5] Alicia Munnell, Francesca Golub-Sass, and Dan Muldoon, "An Update on 401(k) Plans: Insights from the 2007 SCF," Center for Retirement Research at Boston College, March 2009.

included as income.)

Retirement Income Adequacy

There is little consensus about how much constitutes "enough" savings for retirement. Retirement income adequacy may be defined relative to a standard of minimum needs, such as the poverty rate, or to the level of spending households experienced during working years. Some economists and financial advisors consider retirement income adequate if the ratio of retirement income to preretirement income—called the replacement rate—is between 65 percent and 85 percent. The replacement rate generally refers to the ratio of retirement income to preretirement income, but specific calculations of replacement rates can vary. For example, the measure of preretirement income could be based on final pay or a longer term average of pay. Retirees may not need to replace 100 % of preretirement income to maintain living standards for several reasons. For example, retirees will no longer need to save for retirement and their payroll and income tax liability will likely fall. However, some researchers cite uncertainties about future health care costs and future Social Security benefit levels as reasons to suggest a higher replacement rate may be necessary.[6]

VI. Appropriate Sales Practices, Replacement, and Disclosure Requirements

A. Rights and Obligations of the Insurance Producer at Contract Inception

1. Disclosure

When a life agent offers to sell to an elder (meaning 65 or over for these purposes) an annuity, the prospective insured or his/her agent must be advised in writing that sale or liquidation of any financial asset (stock, bond, IRA, etc...) to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result. The purchaser might want to consult independent legal or financial advice before selling or liquidating any assets to purchase any life or annuity products being offered. This generally does not apply to credit life.

2. Illustrations

Any time nonpreprinted illustrations of nonguaranteed values are used in the course of a sales function, the insurer and selling agent must disclose on those illustrations or on an attached cover sheet, in a prominent manner the following statement:

[6] See, for example, Jonathan Skinner, "Are You Sure You're Saving Enough for Retirement," *Journal of Economic Perspectives*, vol. 21, no. 3, Summer 2007, 59-80

"THIS IS AN ILLUSTRATION ONLY. AN ILLUSTRATION IS NOT INTENDED TO PREDICT ACTUAL PERFORMANCE. INTEREST RATES, DIVIDENDS, OR VALUES THAT ARE SET FORTH IN THE ILLUSTRATION ARE NOT GUARANTEED, EXCEPT FOR THOSE ITEMS CLEARLY LABELED AS GUARANTEED."

Preprinted policy illustrations must also contain this notice in 12-point bold print with at least one-half inch space on all four sides, printed on the illustration form itself or on an attached cover sheet, or in the form of a contrasting color sticker placed on the front of the illustration. All preprinted illustrations containing nonguaranteed values shall show the columns of guaranteed values in bold print. All other columns used in the illustration shall be in standard print. "Values" as used here includes cash value, surrender value, and death benefit.

3. Replacement

Policy replacement is a transaction under which a new policy or contract is to be purchased, and for which it is known or should be known to the proposing agent or proposing insurer that, by reason of the transaction, an existing policy or contract has been or is to be:

- Lapsed, forfeited, surrendered or partially surrendered, assigned to a replacing insurer, or otherwise terminated;
- Converted to reduced paid-up insurance, continued as extended term insurance, or otherwise reduced in value by the use of nonforfeiture benefits or other policy values;
- Amended so as to effect a reduction in benefits or in the term for which coverage would otherwise remain in force or for which benefits would be paid;
- Reissued with any reduction in cash value; or
- Used in a financed purchase.

Requirements of 28 TAC Ch 3, NN

The information in this section is from the Texas Administrative Code. 28 TAC Ch 3 Sub NN consists of the following;

Purpose
Definitions
Consumer Notice Content and Format Requirements
Consumer Notice Regarding Replacement for Insurers Using Agents
Direct Response Consumer Notices
Filing Procedures for Substantially Similar Consumer Notices

Purpose The purpose of this subchapter is to specify the content and procedural requirements for consumer notices for life insurance policy and annuity contract replacements as required by the Insurance Code §1114.006.

Definitions When used in this subchapter, the words "agent" and "producer" means, unless the context clearly indicates otherwise, an individual who holds a license under Insurance Code Chapter 4054 and who sells, solicits, or negotiates life insurance or annuities in this state.

Consumer Notice Content and Format Requirements
(a) The text contained in Figure: 28 TAC §3.9504(b), Figure: 28 TAC §3.9505(1) and Figure: 28 TAC §3.9505(2) must be in at least 10 point type and presented in the same order as indicated in each figure and without any change to the specified text, including bolding effects, except as provided in subsections (b), (c), and (d) of this section.
(b) Pursuant to §3.9506 of this subchapter (relating to Filing Procedures for Substantially Similar Consumer Notices), in lieu of using the notices contained in Figure: 28 TAC §3.9504(b) or Figure: 28 TAC §3.9505(1), an insurer may file a notice with the department that is substantially similar to the text contained in Figure: 28 TAC §3.9504(b) or Figure: 28 TAC §3.9505(1) for review and approval by the commissioner. The commissioner will then approve the notice if, in the commissioner's opinion, the notice protects the rights and interests of applicants to at least the same extent as the notices adopted in Figure: 28 TAC §3.9504(b) or Figure: 28 TAC §3.9505(1). An insurer required to send the notice specified in Figure: 28 TAC §3.9505(2) may not file a notice that is substantially similar to that figure for review and approval by the commissioner.
(c) Commissioner approval of a notice is not required if a notice promulgated or approved under this subchapter is used and amendments to that notice are limited to the omission of references not applicable to the product being sold or replaced. For purposes of this subchapter, a reference in any notice required under this subchapter to a product that is being sold or replaced is applicable if the reference could be applicable under any possible circumstances and therefore may not be omitted from the required notice.
(d) An insurer may add a company name and identifying form number to notices specified under this subchapter without obtaining commissioner approval.
(e) The promulgated forms specified in this subchapter are available upon request from the Life, Health & Licensing Division, MC 106-1E, Texas Department of Insurance, P.O. Box 149104, Austin, Texas 78714-9107 or 333 Guadalupe, Austin. Texas 78701, or by accessing the department website at www.tdi.state.tx.us.

Consumer Notice Regarding Replacement for Insurers Using Agents
(a) An agent who initiates an application for a life insurance policy or annuity contract submits to the insurer, with or as part of the application, a statement signed by both the applicant and the agent as to whether the applicant has existing life insurance policies or annuity contracts.
(b) If the applicant states that the applicant does have existing policies or contracts, the agent is required to present and read to the applicant, not later than at the time of taking the application, a notice regarding replacement that contains the text contained in Figure: 28 TAC §3.9504(b), or substantially similar notice filed with the department and approved under this subchapter. The notice is signed by both the applicant and the agent attesting that the notice has been read aloud by the agent or that the applicant did not wish the notice to be read aloud, in which case the agent is not required to read the notice aloud.

Attached Graphic Example

Figure: 28 TAC §3.9504(b)

IMPORTANT NOTICE:
REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

This document must be signed by the applicant and the agent and a copy left with the applicant.

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy and may reduce the amount paid upon the death of the insured.
We want you to understand the effects of replacements before you make your purchase decision and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract? ___ YES ___ NO

2. Are you considering using funds from your existing policies or contracts to pay premiums due on the new policy or contract? ___ YES ___ NO

If you answered “yes” to either of the above questions, list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured or annuitant, and the policy or contract number if available) and whether each policy or contract will be replaced or used as a source of financing:

INSURER NAME	CONTRACT OR POLICY#	INSURED OR ANNUITANT	REPLACED (R) OR FINANCING (F
1. 2. 3.			

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer. Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.

The existing policy or contract is being replaced because

____.

I certify that the responses herein are, to the best of my knowledge, accurate:

______________________________ ______________________
Applicant's Signature and Printed Name Date

__________________________________ ______________________
Agent's Signature and Printed Name Date

I do not want this notice read aloud to me. ____ (Applicants must initial only if they do not want the notice read aloud.)

A replacement may not be in your best interest, or your decision could be a good one.
You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS: Are they affordable?
Could they change?
You're older--are premiums higher for the proposed new policy?

How long will you have to pay premiums on the new policy?
On the old policy?

POLICY VALUES:
New policies usually take longer to build cash values and to pay dividends.
Acquisition costs for the old policy may have been paid, you will incur costs for the new one.
What surrender charges do the policies have?
What expense and sales charges will you pay on the new policy?
Does the new policy provide more insurance coverage?

INSURABILITY:
If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down.
You may need a medical exam for a new policy.
Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
Suicide limitations may begin anew on the new coverage.

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:
How are premiums for both policies being paid?
How will the premiums on your existing policy be affected?
Will a loan be deducted from death benefits?
What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:
Will you pay surrender charges on your old contract?
What are the interest rate guarantees for the new contract?
Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:
What are the tax consequences of buying the new policy?
Is this a tax free exchange? (See your tax advisor.)
Is there a benefit from favorable “grandfathered” treatment of the old policy under the federal tax code?
Will the existing insurer be willing to modify the old policy?
How does the quality and financial stability of the new Company compare with your existing company?

Direct Response Consumer Notices
In the case of a life insurance or annuity application initiated as a result of a direct response solicitation, the insurer inquires whether the applicant, by applying for the proposed policy or contract, intends to replace, discontinue, or change an existing life insurance policy or annuity contract. The inquiry may be included with, or submitted as a part of, each completed application for such policy or contract.
(1) If the insurer has proposed the replacement or if the applicant indicates a replacement is intended and the insurer continues with the replacement, the insurer must send a notice that contains the text in Figure: 28 TAC §3.9505(1), or a substantially similar notice filed with the department and approved under this subchapter.

Attached Graphic example

Figure: 28 TAC §3.9505(1)

IMPORTANT NOTICE:
REPLACEMENT OF LIFE INSURANCE OR ANNUITIES

You are contemplating the purchase of a life insurance policy or annuity contract. In some cases this purchase may involve discontinuing or changing an existing policy or contract. If so, a replacement is occurring. Financed purchases are also considered replacements.

A replacement occurs when a new policy or contract is purchased and, in connection with the sale, you discontinue making premium payments on the existing policy or contract, or an existing policy or contract is surrendered, forfeited, assigned to the replacing insurer, or otherwise terminated or used in a financed purchase.

A financed purchase occurs when the purchase of a new life insurance policy involves the use of funds obtained by the withdrawal or surrender of or by borrowing some or all of the policy values, including accumulated dividends, of an existing policy, to pay all or part of any premium or payment due on the new policy. A financed purchase is a replacement.

You should carefully consider whether a replacement is in your best interests. You will pay acquisition costs and there may be surrender costs deducted from your policy or contract. You may be able to make changes to your existing policy or contract to meet your insurance needs at less cost. A financed purchase will reduce the value of your existing policy and may reduce the amount paid upon the death of the insured.

We want you to understand the effects of replacements and ask that you answer the following questions and consider the questions on the back of this form.

1. Are you considering discontinuing making premium payments, surrendering, forfeiting, assigning to the insurer, or otherwise terminating your existing policy or contract?
____ YES ___ NO

2. Are you considering using funds from your existing policies or contracts to pay premiums
due on the new policy or contract? ___ YES ___ NO

Please list each existing policy or contract you are contemplating replacing (include the name of the insurer, the insured, and the policy or contract number if available) and whether each policy or contract will be replaced or used as a source of financing:

INSURER NAME	CONTRACT OR POLICY #	INSURED OR ANNUITANT	REPLACED (R) OR FINANCING (F)
1.			
2.			
3.			

Make sure you know the facts. Contact your existing company or its agent for information about the old policy or contract. If you request one, an in force illustration, policy summary or available disclosure documents must be sent to you by the existing insurer. Ask for and retain all sales material used by the agent in the sales presentation. Be sure that you are making an informed decision.
I certify that the responses herein are, to the best of my knowledge, accurate:

____ ______________
Applicant's Signature and Printed Name Date

A replacement may not be in your best interest, or your decision could be a good one. You should make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract. One way to do this is to ask the company or agent that sold you your existing policy or contract to provide you with information concerning your existing policy or contract. This may include an illustration of how your existing policy or contract is working now and how it would perform in the future based on certain assumptions. Illustrations should not, however, be used as a sole basis to compare policies or contracts. You should discuss the following with your agent to determine whether replacement or financing your purchase makes sense:

PREMIUMS: Are they affordable?
Could they change?
You're older--are premiums higher for the proposed new policy?
How long will you have to pay premiums on the new policy?
On the old policy?

POLICY VALUES: New policies usually take longer to build cash values and to pay dividends.
Acquisition costs for the old policy may have been paid, you will Incur costs for the new one.
What surrender charges do the policies have?

What expense and sales charges will you pay on the new policy?
Does the new policy provide more insurance coverage?

INSURABILITY: If your health has changed since you bought your old policy, the new one could cost you more, or you could be turned down.
You may need a medical exam for a new policy.
Claims on most new policies for up to the first two years can be denied based on inaccurate statements.
Suicide limitations may begin anew on the new coverage.

IF YOU ARE KEEPING THE OLD POLICY AS WELL AS THE NEW POLICY:
How are premiums for both policies being paid?
How will the premiums on your existing policy be affected?
Will a loan be deducted from death benefits?
What values from the old policy are being used to pay premiums?

IF YOU ARE SURRENDERING AN ANNUITY OR INTEREST SENSITIVE LIFE PRODUCT:
Will you pay surrender charges on your old contract?
What are the interest rate guarantees for the new contract?
Have you compared the contract charges or other policy expenses?

OTHER ISSUES TO CONSIDER FOR ALL TRANSACTIONS:
What are the tax consequences of buying the new policy?
Is this a tax free exchange? (See your tax advisor.)
Is there a benefit from favorable “grandfathered” treatment of the old policy under the federal tax code?
Will the existing insurer be willing to modify the old policy?
How does the quality and financial stability of the new company compare with your existing company?

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(2) If the applicant indicates a replacement or change is not intended or if the applicant fails to respond to the statement, the insurer must send the applicant, with the policy or contract, a new policy or contract notice that contains the statements in Figure: 28 TAC §3.9505(2).
Attached Graphic example

Figure: 28 TAC §3.9505(2)

NOTICE REGARDING REPLACEMENT
REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY?

Are you thinking about buying a new life insurance policy or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one--or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed policy or contract's benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy or contract to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest.

Filing Procedures for Substantially Similar Consumer Notices (a) Beginning with the effective date of this subchapter and ending January 31, 2008, an insurer subject to Insurance Code Chapter 1114 may use a consumer notice that is substantially similar to the text promulgated in Figure: 28 TAC §3.9504(b) or Figure: 28 TAC §3.9505(1) immediately after filing the consumer notice with the department. An insurer who has filed a consumer notice that is substantially similar to the text promulgated in Figure: 28 TAC §3.9504(b) or Figure: 28 TAC §3.9505(1) in the period of time beginning with the effective date of this subchapter and ending on January 31, 2008, will receive a notice of approval or disapproval of the consumer notice from the commissioner. The 'Substantially Similar' rule is subject to several conditions.

4. Free Look Period

Purchasers of new policies should be sure to read the new policy carefully, and ask the agent or company for an explanation of anything not understood. Generally, a 30-day free look period is required for insurance products sold to individuals 60 years of age or over for the purpose of review of the contract. Return during this "free look" period voids the policy, with premiums fully refundable. Consumers should use the time to make sure the policy offers the expected benefits. The policy should be checked for accuracy and for policy limitations, exclusions, or waiting periods. One of the duties of the insurance producer, the individual interfacing with a prospective insured, to see that the consumer understands the 30-day free look period.

5. Importance of Reviewing Sample Contracts

Sample contracts are essential to the potential insured's understanding of the contractual relationship existing between insured and insurer. The insurer must make certain that the sales force is knowledgeable about contract terms and conditions and has up-to-date contract instruments at their disposal. The terms of the contract must be spelled out and potential insured made to understand that what is written down, that which is signed, is the contract. Verbal modifications and assurances are unenforceable. As Hollywood mogul Samuel Goldwyn once said, verbal agreements… "are not worth the paper they are written on."

B. Appropriate Advertising

An insurance advertisement is defined very broadly in as any communication directly or indirectly related to a policy and intended to result in the eventual sale or solicitation of a policy. Advertisements include but are not limited to:

Printed or published materials	Radio & TV	Prepared sales talks
Newspapers & magazines	Billboards	Websites/E-mail
Representations by agents	Leaflets	Descriptive literature
Circulars	Sales aids	Flyers
Illustrations	Form letters	Direct mail
Business cards	Videos	Faxes

1. General Advertising

a. Definition of advertisement

The term ‘advertising’ for the purpose of this discussion of the Texas Insurance Code includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity.

No advertisement can employ words, letters, initials, symbols, or other devices that are so similar to those used by governmental agencies, a nonprofit or charitable institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public. Examples of misleading materials, include, but are not limited to, those which imply any of the following:

- The advertised coverages are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is endorsed by governmental agencies, nonprofit or charitable institutions or senior organizations.

Advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer must have the written approval of the insurer before they may be used. These ads must contain the agent’s name, business address, telephone number, and any insurance license number.
Ads used by insurers or their representatives cannot solicit a particular class by stating or implying that the occupational or other status as members of the class entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

b. Seminars, Classes, Informational Meetings

Beyond any other prohibition on untrue, deceptive, or misleading advertisements, the following protocol must be followed when soliciting seniors in a group; In advertisements for an event where insurance products will be offered for sale, if the terms "seminar," "class," "informational meeting," or some equivalent term is used to characterize the purpose of the public gathering, the words "and insurance sales presentation" must be used immediately following those terms in the same type size and font as those terms.

Each person attending a meeting with a senior shall provide the senior with a business card or other written identification stating the person's name, business address, telephone number, and any insurance license number.

c. Direct Mailers

If a company or insurance producer uses direct mailings, this is considered to be a device designed to produce leads based on a response from a person. Since respondents may be 65 years of age or older, these mailers must prominently disclose the fact that an agent may contact the senior.

d. Advertising Proscriptions

Here is a list of practices in which insurers must not engage when soliciting business;
Advertising may not use the name of a state or political subdivision of a state in a policy name or description.
In the same manner, it is prohibited to use any name, service mark, slogan, symbol, or device in such a way as to imply that the insurance company or its representative is connected with a governmental agency, such as the Social Security Administration.
Advertising may not imply that the reader may lose a right, or privilege, or benefits under federal, state, or local law if the prospect fails to respond to the advertisement.
The insurance company or its representative is prohibited from using an address so as to mislead or deceive as to the true identity, location, or licensing status of the insurer, agent, broker, or other entity.
In the trade name of its insurance policy or certificate, insurers cannot use any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser.

e. Other Advertising Issues

Every licensee must print the license number on advertisements, business cards, and insurance price quotations. The number must be in the type the same size as any address, phone or fax number printed on the card.

Not Considered Advertising- The following materials are not considered to be advertising provided they are not used to urge the purchase, increase, modification, or retention of a policy of insurance(28 TAC Sec 21.102):

- Materials used by an insurance company within its own organization and not for public distribution;
- Communications with policyholders;
- A general announcement sent by a group policyholder to members of the eligible group that a policy has been written or arranged; or
- Correspondence between a prospective group policyholder and an insurer in the course of negotiating a group contract.
- Agent recruitment/training materials, i.e., materials used <u>solely</u> for the training, recruitment, and education of an insurer's personnel, and agents. Statements in such materials that are intended to be used, or that *may* be used, in consumer sales presentations are *not* exempt. We do not assume that *all* agent training material is exempt.

Note: The company may not misrepresent products to its own agents (TIC Sec 543).

f. Fines and Penalties

Violations of advertising regulations are subject to fines. The first offense is $200, $500 for the second offense, and $1,000 for subsequent offenses. The penalty shall not exceed one thousand dollars ($1,000) for any one offense. These fines shall be deposited into the Insurance Fund.

2. Advertising for Persons 65 Years and Older

Advertisement or other device designed to produce leads based on a response from a potential insured which is directed at people age 65 or older is must display and disclose in a prominent manner that an agent may contact the applicant if such is the case. Additionally, an agent who makes contact with a prospective insured as a result of acquiring that person's name from a lead generating device needs to make this fact known to the prospective in the initial contact with the person. Insurance companies and their representatives in Texas must not solicit anyone age 65 and older for the purchase of disability insurance, life insurance, or annuities through the use of a true or fictitious name which is deceptive or misleading with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement.

C. Prohibited Sales Practices

1. Selling Annuities for Medicaid

Annuities cannot be sold to a senior as a means of facilitating eligibility for Medicaid. Married couples can usually protect certain assets from consideration as a means for paying for nursing home costs. These assets would include a home, a vehicle, and monies put aside for a small amount of life insurance and for burial purposes. Medicaid statutes include protections against spousal impoverishment to ensure that when one spouse enters a nursing home, the other spouse has sufficient income and assets to prevent impoverishment, thereby negating any need for financial assistance from the federal or state government. One financial instrument has been used as a means of sheltering assets, thereby potentially increasing costs to the Medicaid program. These instruments are commonly referred to as Medicaid annuities and can potentially reduce the assets held by the institutionalized spouse by converting these assets into an income stream for the community spouse. The main effect is that assets that could have been used to pay for nursing home costs have essentially been transferred to the community spouse, which in turn, means that the Medicaid program has to step in to pay for the nursing home costs of the institutionalized spouse. Annuities may also be used by a single individual in order to maximize the individual’s bequest to his or her heirs.

2. In-Home Solicitations

a. Criteria

In connection with the activities surrounding the sale of annuities to seniors (this includes sale, offering for sale, or generation of leads for the sale of life insurance, including annuities), Any person who meets with a senior in the senior's home is required to deliver a notice in writing to the senior no less than 24 hours prior to that individual's initial meeting in the senior's home.

b. True Content of Meeting

A person may not solicit a sale or order for the sale of an annuity or life insurance policy at the residence of a senior, in person or by telephone, by using any plan, scheme, or ruse that misrepresents the true status or mission of the contact.

3. Unnecessary Replacement

a. Unnecessary Replacement Defined

An act is regarded as a violation of the Texas Insurance Code if an agent or insurer recommends the replacement or conservation of an existing policy by use of a materially inaccurate presentation or comparison of an existing contract's premiums and benefits or dividends and values, if any, or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity. In this context "unnecessary replacement" means the sale of an annuity to replace an existing annuity that requires that the insured will pay a surrender charge for the annuity that is being replaced and that does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary. Patterns of action by policyowners who purchase replacement policies from the same agent after indicating on applications that replacement is not involved, shall constitute a rebuttable presumption of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall constitute a rebuttable presumption of the agent's intent to violate the unnecessary replacement prohibition. It is acceptable for an agent to use additional material beyond that which is required so long as it is not in violation of any statute or regulation.

b. Examples of unnecessary replacement

A replacement annuity contract is one where the purchase results in the lapse, forfeiture, or surrender of part of all of an existing annuity contract or life insurance policy. As discussed in this section, there are regulations that require certain procedures to be followed before the issuance of a replacement annuity contract.

An example of unnecessary replacement is the unnecessary replacement of an older policy and using its cash value to pay for a brand new policy. An insurer may try to push the sales force to sell more of the company's proprietary products. While management is not saying, "switch," their not saying "don't switch." Agents may be subjected to sales meetings given by insurers or wholesalers and strongly encouraged to move policies that are part of ‘the system.’ If business is slow, it may by hard for agents to overlook who is paying the biggest commissions or can promise entrée to more business.

The personal finance sector is constantly changing, and consumers are regularly approached and urged to re-assess their investment and insurance portfolios. This regularly results in changes to the existing portfolios being proposed and often the consumer does not know whether a change is really beneficial or not. Sometimes a new product tends to look as if it is more beneficial at first sight. For example, a replacement policy may offer a tempting short-term teaser rate, but contain restrictive withdrawal and surrender features. It is always advisable to contact the insurer or intermediary from whom the original product was obtained and check whether the new product is in reality more beneficial. In terms of policyholder protection, the insured should consider details of any commission earned by the person selling the policy. Where a senior is being advised to replace an annuity policy, it is important to think about the details of any commission paid by the insurer, as well as any up-front or ongoing fees which the agent earns from the new product provider.

D. Importance of Determining Client Suitability

NAIC Senior Protection in Annuity Transactions Model Act- During its 2003 fall national meeting, the National Association of Insurance Commissioners (NAIC) adopted a model regulation designed to help protect senior consumers when they purchase or exchange annuity products. The new measure is designed to ensure that the insurance needs and financial objectives of senior consumers (age 65 or older) are appropriately addressed. The Act is intended to provide senior consumers peace of mind that they are well protected when making financial decisions, according to an NAIC press release. The new regulation sets forth standards and procedures for insurers and insurance producers relating to the purchase or exchange of annuity products involving senior consumers as follows:

In recommending to a senior consumer the purchase of an annuity or exchange of an annuity that results in another insurance transaction, the insurance producer, or the insurer where no producer is involved, must have reasonable grounds for believing that the recommendation is suitable for the senior consumer on the basis of the facts disclosed by the senior consumer as to his or her investments and other insurance products and as to his or her financial situation and needs.
Prior to the purchase or exchange of an annuity based on a recommendation, there must be reasonable efforts to obtain information about the senior consumer’s financial status, tax status, investment objectives, and other information that could be reasonably considered by the insurance producer or insurer in making recommendations to the senior consumer.
Neither an insurance producer, or an insurer where no producer is involved, will have any obligation to a senior consumer related to any annuity transaction if a consumer refuses to provide relevant information requested by the insurer or insurance producer, decides to enter into an insurance transaction that is not based on a recommendation of the insurer or insurance producer, or fails to provide complete or accurate information.
An insurer or insurance producer’s recommendation will be considered reasonable under the circumstances actually known to the insurer or producer at the time of the recommendation.
An insurer must assure that a system to supervise recommendations is in place that is reasonably designed to achieve compliance with the regulation. An insurer may meet its obligations by conducting periodic reviews or by contracting with a third party, such

as an independent agency, to maintain the supervisory system and to provide certification to the insurer that the supervision is occurring.

Compliance with the conduct rules of the National Association of Securities Dealers Conduct Rules regarding suitability, or the rules of another national organization recognized by the Texas DOI satisfies the requirements for the recommendation of variable annuities. This reliance on a third party does not affect or limit the Department's ability to enforce regulations.

Additionally, the model regulation does exempt insurers and insurance producers from recommendations involving direct-response solicitations (where no recommendations are made based on information provided by the consumer pursuant to the regulation), as well as various funded contracts covered under federal law.

1. Need for Information Prior to Making Recommendations

It is the duty of agents to reminded potential purchasers that annuities are not suitable for all investors, particularly those who may need cash for short term needs. This is especially true with variable annuities, whose hybridization of both securities and insurance features may be more difficult to understand.

In the largest disciplinary complaint ever filed up to that time by the National Association of Securities Dealers (NASD), it was reported on January 15, 2004 that the agency had charged securities broker/dealer Waddell and Reed of Overland Park, Kansas with “selling unsuitable investments to thousands of clients.” The press release indicated that the “firm advised 6,700 clients to switch their variable annuities from one insurer to another in transactions that generated millions of dollars in fees for the firm but did not benefit the clients. Roughly 20% of the exchanges were likely to result in the clients’ losing money, according to the NASD.” Supervisory and suitability charges were also leveled against the firm and two senior executives. Along with the disciplinary announcement mentioned above, the Securities and Exchange Commission and the NASD advise public investors to ask questions before buying variable annuities and life insurance products.

a. The Consumer’s Financial Status

Issues should be addressed by seniors (or on their behalf) before purchasing an annuity. Among the considerations are the following; i. income, ii. Liquid assets, iii. Presence of comprehensive LTC insurance.

Potential purchasers should be asking such questions as;
Might I need this money in the short term?
Do I have enough money now to purchase this product?
What am I paying for each feature?
Are the extra fees worth it for me?
Will I have to take out a home loan to keep up with payments?

Insurance agents recommending annuities to a client age 65 or older must have reasonable grounds for believing that the annuity is appropriate for the consumer. This is after the representative obtains the necessary client financial information when determining annuity suitability. The rules also say that producers do not have obligations to the client if the senior refuses to provide pertinent information or decides to enter into an insurance transaction that was not recommended by the producer.

Insurers must design compliance standards to ensure that senior clients are getting appropriate advice and that producers are following the rules. Companies are charged with the responsibility to make sure that their agents or producers are getting the right information to serve the consumer well. Insurers have a responsibility to set up guidelines and education and to monitor their insurance producers. It is the responsibility of the agent to verify that all compliance issues, all financial suitability forms promulgated by the insurer for a particular policy or class of policies are presented to the prospective annuity purchaser.

Regulatory turf issues are not ruled out. A spokesperson for the American Council of Life Insurers said that with variable annuities included in the NAIC proposal, there is a potential conflict of the supervisory duties of broker-dealers under the NASD rules. The Senior Protection Annuity Model Act provisions say the supervisory role rests with the insurance company. The NASD requires that broker-dealers supervise its reps that sell insurance with already-created compliance rules. It is not clear how the two sets of rules would mesh. Nonetheless, the licensee must satisfy the Texas Insurance Code and pronouncements of the Department of Insurance.

b. Consumer Tax Status

A primary concern for consumers is determining how much income tax will be owed on payments from the annuity contract. The tax treatment of a distribution depends on if it is received before or after the annuity starting date, and on the amount of the investment. Cash withdrawals from deferred or retirement annuities before age 59½ are generally subject to a 10% penalty tax on the portion included in gross income. Payments received on or after the annuity starting date are treated differently.

The General Rule- This is a calculation method prescribed by the IRS. Under the General Rule, an individual determines the tax-free part of each annuity payment based on the ratio of the cost of the contract to the total expected return. Expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. To figure it, a person must use life expectancy (actuarial) tables prescribed by the IRS. The General Rule must be used if a person receives pension or annuity payments from:
1) A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2) A qualified plan if the person is age 75 or older on the annuity starting date and his or her annuity payments are guaranteed for at least 5 years.

c. Consumer Investment Objectives

It is generally considered that the first step in establishing financial goals is to analyze the current financial condition. This can be easily accomplished by examining assets and establishing a budget. Budgeting should also include cash reserves for emergencies and insurance coverage. Once the current financial condition has been evaluated, the second step is to establish broad investment objectives. There are essentially three primary investment goals:

Preservation of principal.
Generation of stable after-tax income.
Appreciation of principal.

Investment Objectives- Like so many aspects of life, terms of art can sometimes hinder effective communication. In one allegorical case, the broker testified that he asked his client what his investment objectives were and the client replied, "To Make Money!" This cavalier response sent a message that the client was willing to take big risks in order to get big gains. The broker noted "speculation" as the client's investment objective, yet the client testified that what he meant was that he wanted his money to grow, but not at the expense of his principal.
"Investment objective" is what is known as a term of art in the securities industry. It does not mean that an investor knows what specific investments he or she wants to make. Nor does it require some abstract or philosophical response. Standard choices when considering investment objectives are:
Preservation of Principal- The investor does not want to lose any of the money being invested. Such people are generally more comfortable with conservative, stable investments and are not willing to take any risk of principal (the only risk one might be willing to assume is the amount and certainty of the income or appreciation).
Stable Income- The investor wants to generate income from the money being invested and is willing to take some small risk in order to receive increased income.
Appreciation of Principal- The investor has more of a long-term investment horizon. He or she may be saving for a future goal and is willing to take some risk (approximately 10% of portfolio is a common rule of thumb) in order to increase the growth potential. Or it could be that diversification to achieve a combination of both income and some capital appreciation is desired. Such individuals are comfortable with moderate risk.
Other investment categories include-
Aggressive Growth – Investing in order to maximize returns.
Speculation - The investor is willing to lose all or a substantial portion of the money.

The Dilemma
Most customer disputes center on the issue of what were the client's investment objectives. Setting investment objectives can be difficult for several reasons. First, the great majority of investors don't have a clear understanding of what they want to do. And for those who do, they do not clearly express it. Second, insurers or brokerage firms usually only require a few pre-printed boxes of investment objectives (such as those above) be shown on the new account form. These categories may prove to be either too limiting or too susceptible to interpretation. Look at the issue from another perspective; the agent checks all of the boxes for the client's investment objectives, reasoning that the client said he or she wanted to do a little of everything. This defeats the purpose of the information – There is no yardstick or guide to ensure that suitable investments are being made? Arguably, everything is suitable and the agent has carte blanche to recommend anything and everything under the sun to the client.
Individuals must make sure that investment objectives reflect the overall guideline for how he or she wants the investments handled.

E. Selling to the Senior Market

The potential of the senior market is huge and growing rapidly. If adults age 55 and over are included, the senior market is projected to exceed 91,000,000 by the year 2030, based on U.S. Census data. This has significant bearing on both for-profit and non-profit marketing efforts. Seniors and pre-retirees who plan now by building the best asset management strategy will reap the greatest benefit from those who market financial products to seniors. Senior-focused selling, active networking and focusing on senior needs, will provide for growth in this market. An understanding the dynamics of this market will benefit the insurance industry. It will also be of assistance to seniors, who will have more information and product choice at their disposal.

Gray hair is appearing at an ever-increasing clip in the workplace. Senior Americans comprise 10 percent of the workforce, but account for 22 percent of the nation's job growth. By 2015, the number of employees over 55 is expected to reach 31.9 million, compared to 18.4 million in 2000. According to the Bureau of Labor Statistics, workers aged 55 and over will increase twice as fast as the aggregate workforce. The senior market is as deep as it is wide. One of its more interesting characteristics is its diversity. In 1996, the baby boomer generation of approximately 78 million began turning 50 at the rate of 300,000 per month. In an unprecedented paradigm shift, both parents and their children are now members of the senior population, with ages ranging from 50 to over 100 and experiences ranging from the Great Depression to Woodstock.

Risk and the Senior Client- Risk is traditionally defined in terms of uncertainty, the uncertainty concerning the occurrence of a loss. The major risk associated with old age is insufficient income during retirement. When workers retire, they lose their normal work earnings. Unless they have accumulated sufficient financial assets on which to draw, or have access to other sources of retirement income, such as Social Security or a private pension, they will be confronted with a serious problem of economic insecurity. Retired persons generally own insufficient financial assets. Financial assets are important since investment income can supplement any retirement income, and the assets provide a cushion for emergencies.

Application of basic sales principles to the senior market should play a key role in a thorough marketing plan with the greatest potential for success. Here are ten key points to remember in dealing with the senior market;

1. Never think that the elderly market is “old.” They do not consider themselves old.
2. Never attempt to scare them into buying. Scare tactics turn people off.
3. Always treat them as equals
4. Do not pander or be obsequious. Never talk down; they are not dumb. In fact, they are probably smarter -and richer -than you.
5. Do not hoodwink or con. Seniors are skeptical; they have seen it all before.
6. Do not paint all seniors with a broad brush; they are not all alike. There are several age cohorts above age 50 and numerous niche markets.
7. Guarantees are taken seriously. Seniors fear being taken.
8. Glitz and gaudiness have no place. Seniors are conservative about expenditures as a result of being on fixed incomes.
9. Ads should look like ads. No elaborate *fonts*. Type should be at least 12 point in an easy to follow format, not condensed or s p r e a d.
10. As with any other client, treat seniors with respect.

1. Product complexity

The stage may be set for a national crisis in retirement planning, as many seniors are underestimating their own longevity and are not saving enough for retirement, according to a recent survey[7]. Questions were designed to test participant's knowledge of retirement and income planning statistics and issues involving longevity and its impact. Consumers are underestimating their own longevity and not saving adequately for their retirement, and this sets the stage for a national crisis in retirement planning. Individuals aged 56 to 65 within at least five years of retirement were asked to respond to a quiz designed to test their knowledge of retirement and income planning statistics and issues in the areas of:

- Longevity and its impact
- Income, expenses, and inflation in retirement
- Annuities as a retirement planning tool
- Long-term care and protection of assets

On average, respondents answered only five of the fifteen questions correctly. This failing score of 33% suggests that seniors have misconceptions about issues affecting their retirement. Specifically, they underestimated the life expectancy of a 65-year old (and how many years they are likely to spend in retirement), and they do not consider longevity a significant financial risk in terms of appropriately planning for their retirement. Further, their answers revealed that they underestimate how much money they should be saving compared to experts' recommendations and that they may intend to withdraw from their retirement savings at levels considered too high. They demonstrated a lack of understanding of the extended time horizon they would be living in retirement and of inflation's full effect on the future value of their money. Their responses also indicated that they underestimate long-term care expenses and do not fully understand annuities – the primary insurance product designed to protect retirees' income.

Cost Factors in Resource Allocation

In a dynamically changing economic environment, holding on to assets can become as cutthroat as survival in one of the reality-based television shows; which means that seniors have to continually be on their toes. They must anticipate and assess their need for new products or services in order to stay ahead of the game. Faced with the dilemma of unlimited strategic choices but limited resources, seniors must seek help from representatives of the financial services industry to assist them find the best course of action. There are a variety of consumer costs associated with purchasing insurance or financial products. Product complexity can lead down the path of incorrect decisions and the purchase of incorrect or overpriced annuities or consumer products. Greater product complexity is driven by an increased volume and diversity of offerings. Straight-life to variable to second-to-die policies are offered by indirect sales, product seminars, and personal sales calls from anybody who can squeeze a name out of a database.

Take banks as an example, with changes brought about by the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 garners the insurer new access to customers of the banking institution. Even at relatively low penetration rates, a substantial volume of low cost business can be generated by the bank customer list.

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[7] The "MetLife Retirement IQ Test" was developed by the MetLife Mature Market Institute and in May 2003 surveyed 1,201 men and women between the ages of 55 and 65 who are within five years of retirement.

Furthermore, insurance product complexity makes the sale of insurance products more difficult for new channels, and experience suggests that tenure in product marketing is a strong contributor to success. Product integration is the holy grail of both ‘one stop shopping’ and ‘financial services convergence’. Consumers clearly seek convenience, performance, and trust in their contemporary buying habits. Product proliferation, with or without profit subsidization from one product to another, is unlikely to be a sustainable market strategy. Linking financial services products in a seamless, efficient package, designed for particular market segments and life cycle needs, has great conceptual and ‘street’ appeal. Whether or not the cost of delivering such a program of services, principally driven by the technology requirements, is anybody’s guess.

2. Issue of Buyer Competence

a. Short term memory/judgment

Agents should be aware of ways to recognize that a senior may lack the short-term memory and judgment needed to assess a policy or annuity. The brain's ability to learn and remember recent events can change over time due to any number of reasons. Researchers and doctors working with diseases like Bipolar depression and Alzheimer's are finding out that the brain of a disease victim suffers decrements (reductions) in its short-term memory and learning capacities.

Insurance agents are now charged by the legislature to make objective evaluations as to the ability of an individual to contract. Examples of short-term memory capability test indicators include the following;

- Count backwards from 100 by sevens- Thus, 93, 86, 79, 72, 65, … and so on.
- “I am going to say three words- bacon, brown, skillet.” (Any three words will do, but associated words are acceptable.) “We will discuss other matters for a few minutes, then you will need to recite the words back to me.”

These short-term memory test indicators are for illustrative purposes only. Any tests or indicators should be previewed and probably approved by the insurance company the agent is representing.

b. Short-term Memory and Judgment

Consider the case where the ‘indicators’ show "…that a prospective insured may lack the short-term memory or judgment to knowingly purchase an insurance product…" What is the agent to do?

A senior who may exhibit short-term memory loss would not seem to fall into the *non compos* class. However, an insurance contract made by a person of unsound mind before a judicial determination of incapacity has been determined, is subject to rescission. Bolstering the case for such a rescission would be proof that a person is substantially unable to manage their financial affairs or resist fraud or undue influence. A person lacking sufficient mental capacity to enter into a contract is not held competent even if he has not been judged insane by a court. He or she is one who is unable to understand the effect and nature of their act in making the agreement. An insane person's voidable contract can be ratified or disaffirmed when he or she is again sane, or by the guardian during insanity or his or her representative after death.

3. Unique Ethics and Compliance Issues

Complexity and competence issues as discussed above put the agent in an evaluation/judgment quandary requiring the skills of King Solomon. Is this product too complex for understanding? Is a particular senior citizen lacking the memory skills to comprehend what is being presented? The way to avoid problems in this area is to employ safeguards ethical safeguards:

- **Document client files-** A properly documented file contains complete and accurate accounts of client-agent interaction. This allows the agent to properly account for the need for insurance and substantiates the reason for the sale.
- **Change can cause problems-** With any new product or change in law, seek professional legal opinions as to proper procedure. Insurance providers will no doubt have promulgated procedures they feel are appropriate in dealing with seniors when selling a particular product.
- **Service is essential-** Transparency and self-policing, honesty and forthrightness are items hard to quantify, but an agent who maintains a checklist of integrity will seldom have to regret any action he or she has taken.

4. Suitability for the Senior Market

Insurance professionals must consider, among other things, tax consequences, surrender charges and loss of benefits (such as death, living or other contractual benefits). An insurance professional cannot adequately determine the suitability of a transaction without knowing the material features of the annuity in question. An agent's understanding of the features of an annuity product is an important component of two concepts;

4. That, the agent determine, after appropriate due diligence, whether the product is suitable for at least *some* investors.
5. That the agent determines whether the product is suitable for the particular customer at issue (customer-specific suitability).

It is important that seniors are not deceived into tying up their money in long term annuities when they cannot pay their living expenses, and are fully aware of the products they are purchasing. Agents should utilize comprehensive procedures to ensure better senior protection[8];

- Conduct an elevated review on all applications submitted from specified individuals 65 years and older
- Follow up by telephone with all applicants seventy-five years of age or older, and those living in assisted living facilities, to confirm their thorough understanding of the purchased product
- Amend annuity contracts to make them more understandable to consumers
- Clearly, plainly, and conspicuously disclose the terms of premium bonuses being offered

[8] Insurance Commissioner Poizner Announces $10 Million Settlement With Allianz For Allegedly Deceiving Seniors Into Purchasing Unsuitable Annuities, 02/14/08