



# Fixed Deferred Annuities

# The Annuity Market

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- If you were to go outside, hand the next person you see a check, and ask him or her to use it to purchase a certificate of deposit, the typical person would know:
  - Where to buy a CD
  - That CD's are available in different durations
  - That they have an interest rate set by the bank that is guaranteed for the duration chosen
  
- If you were to go outside, hand that same person a check, and ask him or her to use it to purchase an annuity, the typical person would likely not know what an annuity is, how they work, or where one could be purchased

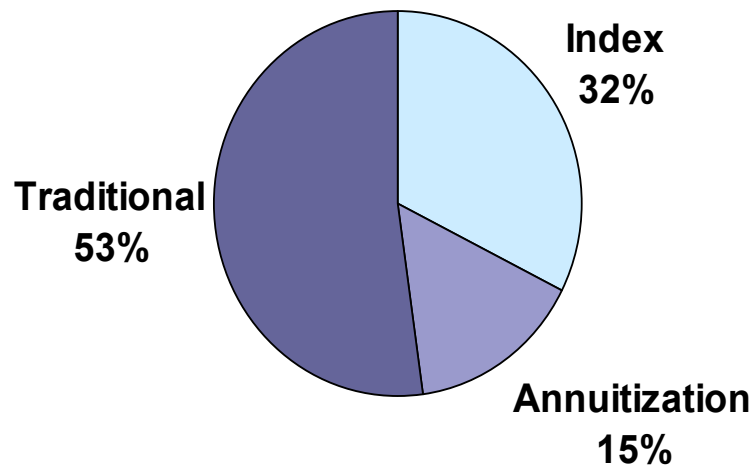
# The Annuity Market, *continued*

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- And yet, there is approximately twice as much money in annuities as there is in bank certificates of deposit
  
- Why is that?
  - Annuities offer certain advantages over CD's
  - Any agent with a life insurance license can sell an annuity and earn a commission for doing so – many of your colleagues are deriving substantial additional income by offering annuities to their customers

# The Annuity Market, *continued*

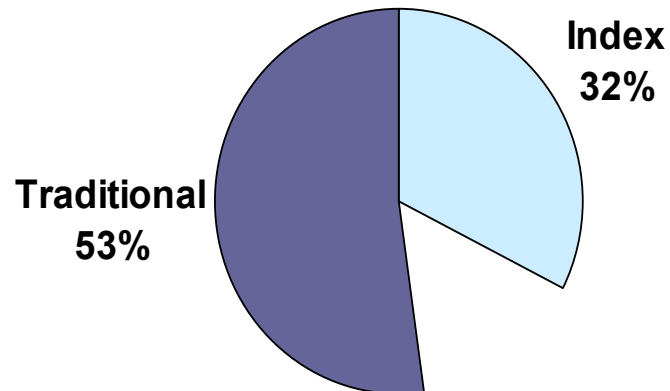
- The annuity market in 2006 consisted of \$236 billion in new sales, of which \$75 billion was fixed annuities
- Fixed annuities consist of:
  - Traditional deferred annuities where the carrier declares a credited interest rate,
  - Index annuities where the client's credited rate depends upon the performance of a stock market index, and
  - Annuities in a payout or "annuitization" phase



Source: LIMRA

# The Annuity Market, *continued*

- This class will focus on fixed annuities in their “deferral” or “accumulation” phase
- Mountain CE offers another class on immediate annuities, that is, fixed annuities in their “annuitization” phase



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# 1. Introduction to Fixed Annuities

# What are fixed annuities?

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- Retirement savings plans offered by insurance companies
- An individual can save for retirement using an Individual Retirement Account (IRA), which can be:
  - A certificate of deposit at a bank
  - Holdings of stock at a brokerage house
  - An account at a mutual fund company
  - An annuity at an insurance company
  - Or a variety of other things
- Or, one can save for retirement with regular savings, so-called “non-qualified money”, which can also be any of the above

In other words, an annuity is just money you have put on deposit with an insurance company rather than a bank, brokerage house, or mutual fund company

# Why offer fixed annuities?

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You should have confidence offering annuities because:

- Consumer awareness of annuities is relatively low, so when you present annuities, you are sharing new information with your clients
- Fixed annuities are offered nearly only by insurance agents, so there is little direct competition
- Fixed annuities are easy to understand and have key benefits over other savings vehicles
- If you have clients from sales of other insurance products, annuities allow you to serve their retirement savings needs as well

# What are their key advantages?

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Why would anyone want to put their money on deposit with an insurance company?

- Safety
- Tax Advantages
- Yield
- Liquidity
- Estate Advantages

# What are their key advantages?, *continued*

## ■ Safety

- Fixed annuities provide 3 levels of protection
- Notice that a bank CD only offers the first 2
- Levels of protection
  1. All fixed annuities contractually guarantee that your principal is protected from loss, subject only to a surrender charge, which is an avoidable charge
  2. In the event that the financial condition of an insurer becomes impaired, each state has a guaranty fund to pay claims, up to a maximum limit per annuity owner
  3. In the event that an annuity owner wants to get a regulator involved in any dispute with an insurance company, state governments regulate insurance companies, so the regulator is local

# What are their key advantages?, *continued*

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## ■ Tax Advantages

- As interest is credited to your annuity, it is not considered taxable income until you withdraw it
- You get triple compounding: interest on your principal, interest on your interest, and interest on the taxes you do not have to pay until later
- To encourage using this savings only for retirement, there is a 10% tax penalty on any withdrawal of interest prior to age 59½

## ■ Yield

- Some annuities credit an interest rate set by the company, and the rate is typically higher than the interest rates available on CD's, savings accounts, or money market funds
- Some annuities credit an interest rate that is tied to the performance of a stock market index, and these exciting annuities offer excellent upside potential without risk to principal

# What are their key advantages?, *continued*

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- **Liquidity**
  - All annuities have surrender charges, but during the surrender charge period, annuities allow for periodic penalty-free partial withdrawals and often provide for a waiver of the surrender charge for certain hardships
  - The surrender charge is avoided by taking no withdrawals in excess of the penalty-free partial withdrawal allowance until the surrender charge period is over
- **Estate Advantages**
  - At death, annuity proceeds are paid directly to the designated beneficiaries without the delays and expenses associated with probate



## 2. How Fixed Annuities Work

# Annuity Terminology

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- You start an annuity by sending a deposit (called a “premium”) to the insurance company
  - Depending upon the annuity’s provisions, the owner may have the ability to pay additional premiums into the account value
- The premium goes into the annuity’s account value, which grows with interest
  - The account value is simply the premiums paid plus any interest credited less any withdrawals taken

# Annuity Terminology, *continued*

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- The owner has the ability to take withdrawals (called “partial withdrawals” or “partial surrenders”) from the account value
  - Doing so may incur a back-end sales charge, called a “surrender charge”
  - Most annuities allow some small portion of the account value to be withdrawn every year without a surrender charge, and this portion is often called the “penalty free withdrawal amount”
  - Withdrawals may be a taxable event and, if taken prior to age 59½, can trigger a 10% penalty tax
  
- The owner also has the ability to terminate the contract and receive the account value, less any surrender charge

# Annuity Terminology, *continued*

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- If the owner dies, the owner's beneficiary receives the "death benefit", which is usually equal to the account value, possibly less a surrender charge
  - The beneficiary has no rights under the contract, other than to receive the death benefit

# How Fixed Interest Rate Annuities Credit Interest

- Interest rates are declared in advance by the company
  - With fixed interest rate annuities, interest rates are declared in advance by the company and are typically guaranteed not to change for one or more years at a time
  - The interest rates are typically set at the sole discretion of the carrier
    - Since most products have a surrender charge duration that exceeds the interest rate guarantee duration, the agent must evaluate the carrier's likelihood to be fair to its customers in setting renewal rates
  - First year interest rates often include a bonus
    - For example, the carrier may say that a first year interest rate of 5.5% includes a 2% bonus, and the "base rate" is 3.5%
    - The base rate is not a guarantee, it is merely an indication of what the first year rate would be without the bonus, and it gives a good indication of what sort of renewal rate the company plans to declare in the second contract year

## How Fixed Interest Rate Annuities Credit Interest, *cont'd*

- Renewal rate strategies followed by carriers differ
  - Most carriers use a “new money” strategy
    - Which means that premiums being received now are receiving a different credited interest rate from premiums received previously
    - Which means that there are many different interest rates being credited to the annuity contracts they have in force
  - Some carriers use a “portfolio rate” strategy
    - Which means that all the account value in a certain annuity plan is being credited the same interest rate
  - Carriers tend to invest annuity premiums primarily in long-term bonds
    - This means that if interest rates subsequently rise, the carrier’s earned interest rate on the assets backing in force contracts is not rising, hence the carrier typically cannot afford to substantially increase the interest rates it is crediting on in force contracts

## How Fixed Interest Rate Annuities Credit Interest, *cont'd*

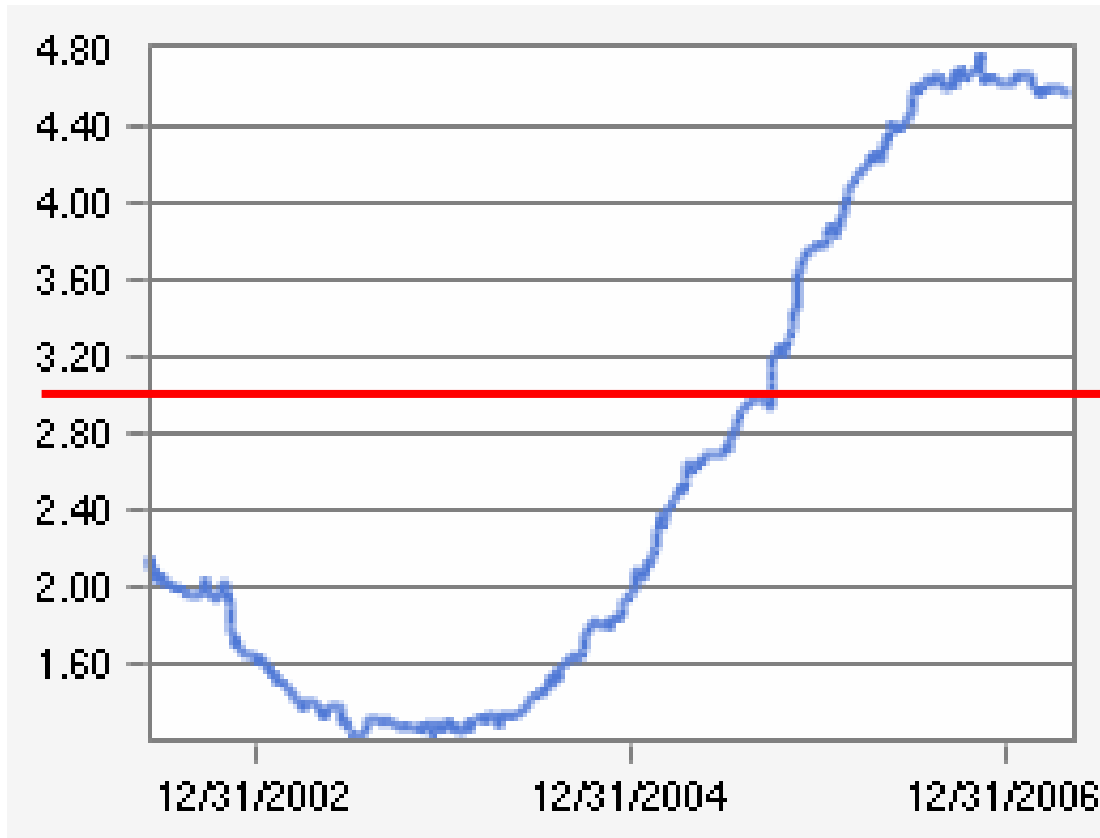
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- Interest rates are guaranteed never to fall below a contractually guaranteed minimum rate
  - With most contracts, this rate is set at issue and is guaranteed for the life of the contract
  - With some contracts, this rate may vary over time, typically between 1% and 3%, depending upon a formula tied to the yields on 5-year Treasury notes
  - Regardless of which method is used, this lifetime minimum guaranteed interest rate can prove to be a valuable feature if market interest rates fall to historic lows

## How Fixed Interest Rate Annuities Credit Interest, *cont'd*

CD's do not guarantee a minimum interest rate forever ...

but annuities do!



Fixed annuities became increasingly popular when 6-month bank CD rates were below 3%.

Source: BankRate.com

# How Index Annuities Credit Interest

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- What is an index annuity?
  - It is a fixed annuity with an interest rate that is linked to a stock market index
  - At the beginning of a period (such as a policy year), the carrier declares a formula that will be used to calculate the interest credit at the end of the policy year
    - For example, the formula might be:
      - The entire percentage gain in the Standard & Poor's 500 stock market index up to a maximum of 7.5%
      - But no less than 0%
  - Interest is then credited at the end of the period after the stock market index results for the period are known

# How Index Annuities Credit Interest, *continued*

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- The appeal of an index annuity is that you get some element of stock market participation, along with some protection from loss
- Keep in mind that the carrier can usually change some element of the formula from time to time, so you have the same renewal rate issues as you have with all fixed annuities

# How Index Annuities Credit Interest, *continued*

Typical stock market indices:

## **S&P 500**

Includes 500 large companies in major industries, most index annuities are tied to this index

## **Dow Jones IA**

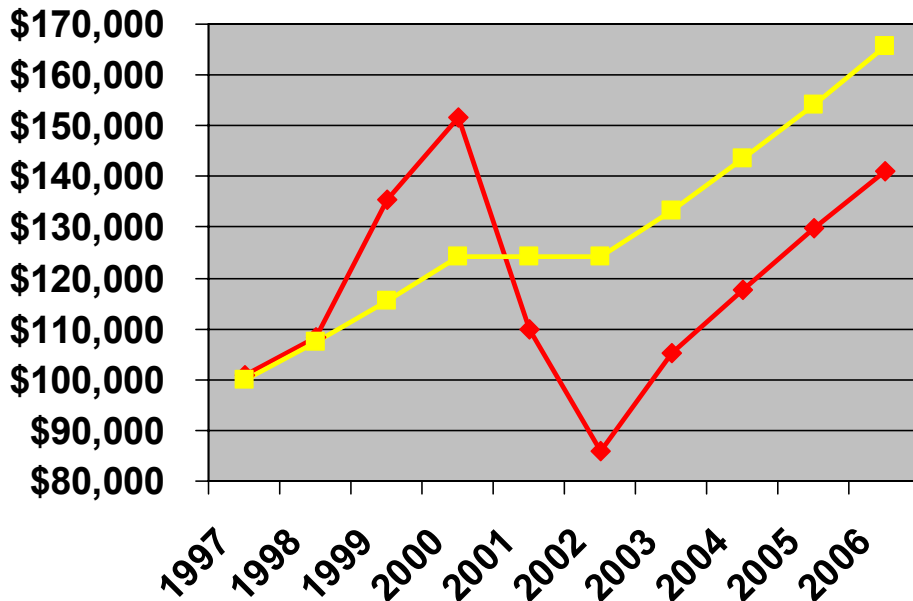
30 very large companies that represent about  $\frac{1}{4}$  of the value listed on the New York Stock Exchange

## **NASDAQ 100**

100 large companies listed on the Nasdaq exchange, many from the technology sector

# How Index Annuities Credit Interest, *continued*

Notice the value of the protection provided by an index annuity. Suppose that on 9/30/97 you had purchased a \$100,000 index annuity that annually credited the increase in the S&P 500 index, not to exceed an annual cap of 7.5%. Here is how the value of your annuity would compare to a direct investment in the S&P 500 index.



Index annuity = \$165,690

S&P 500 = \$141,020

A \$24,670 difference!

# How Index Annuities Credit Interest, *continued*

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- What license is required to sell an index annuity?
  - An index annuity is not a security, it is a fixed annuity
  - Therefore, only your life insurance license is required

# Why Annuities Have Surrender Charges

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- Carriers need protection from annuities being cancelled soon after issue
  - Annuities typically pay a hefty up-front commission to the agent, and the carrier needs time to recover that expense
  - Also, since carriers invest in long-term bonds and cannot affordably increase the credited rate on in force contracts as interest rates rise, they need protection from a “run on the bank” scenario

# Why Annuities Have Surrender Charges, *continued*

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- How do they achieve that protection?
  - Surrender charges
    - Typically a percentage of the account value declining over time for a certain number of years from the policy issue date
  - Market value adjustment
    - As interest rates rise, the value of the bonds held by the insurer fall
    - A market value adjustment essentially passes through that change in market value to the consumer
    - The market value adjustment feature usually ends when the surrender charge no longer applies



### 3. State Guaranty Funds

# State Guaranty Funds

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- Obligations of an annuity contract are guaranteed by the insurer
- So, the financial strength of the carrier is a concern in the purchase decision
  
- Various ratings agencies give opinions of the financial strength of carriers
  - A.M. Best
  - Standard and Poor's
  - Moody's
  - Fitch
  
- In the event that the financial condition of an insurer becomes impaired, each state has a guaranty fund to help pay claims

# State Guaranty Funds, *continued*

- State laws specify the lines of insurance covered by the guaranty fund and the dollar amounts payable
- Most states restrict insurance companies and agents from advertising the guaranty funds' availability
- The maximum liability for cash value of an annuity contract in most states is \$100,000
  - Notable exceptions:
    - \$200,000 in Utah
    - \$300,000 in Arkansas, DC, North Carolina, Oklahoma, South Carolina, Wisconsin
    - \$500,000 in New York, Washington
- An excellent source of more detailed and current information is the National Organization of Life and Health Guaranty Associations website
  - <http://www.nolhga.org>



## 4. Tax Treatment

# Tax Treatment

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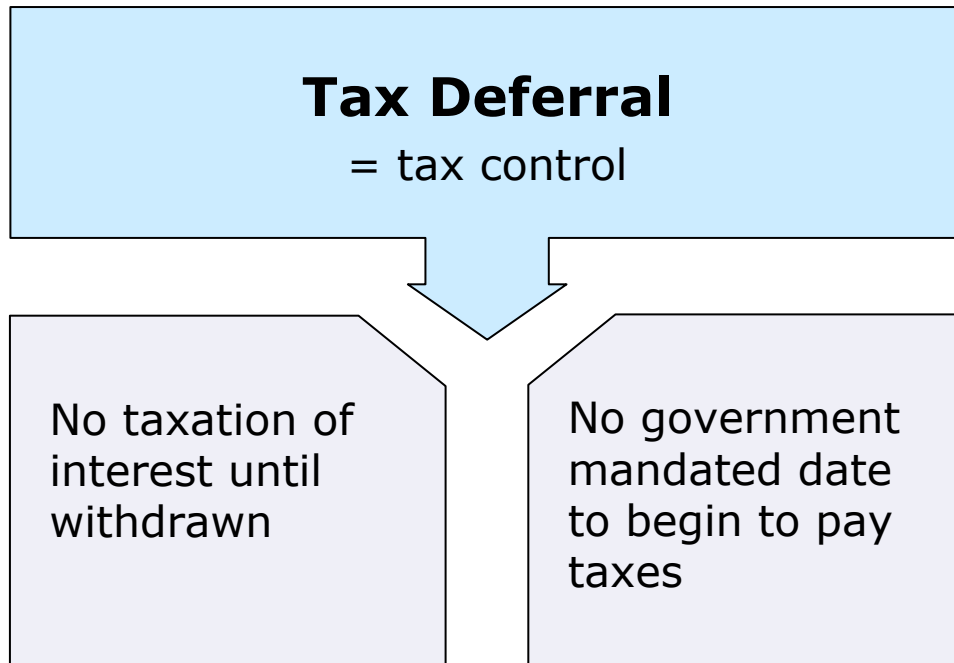
- The tax treatment of an annuity varies depending upon whether the money is treated as non-qualified money or qualified money
  
- What is non-qualified money?
  - Money in an account not designated as a tax-qualified plan such as an Individual Retirement Account (IRA), Roth IRA, 401(k), 403(b), etc.
    - For example, savings that you accumulate in your checking account is non-qualified money
  
- What is qualified money?
  - Money in an account designated as a tax-qualified plan such as an Individual Retirement Account (IRA), Roth IRA, 401(k), 403(b), etc.
    - For example, savings that you accumulate in your 401(k) plan at work is qualified money

# Tax Treatment, *continued*

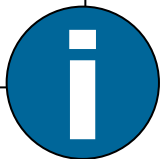
	Non-qualified	Qualified IRA	Qualified Roth IRA
Contributions	Not tax deductible, unlimited	Tax deductible, limited	Not tax deductible, limited
Interest While Accumulating	<b>Tax deferred</b>	<b>Tax deferred</b>	<b>Tax deferred</b>
Withdrawals	Interest is taxable	Entire amount is taxable	Tax free (if certain rules are met)
Extra considerations before age 59½	10% penalty tax on interest withdrawn	10% penalty tax on entire withdrawal	10% penalty tax on interest withdrawn

# Non-Qualified Annuities

- During the deferral phase of a non-qualified annuity, there is no taxation of the interest that is credited to the annuity until the interest is withdrawn

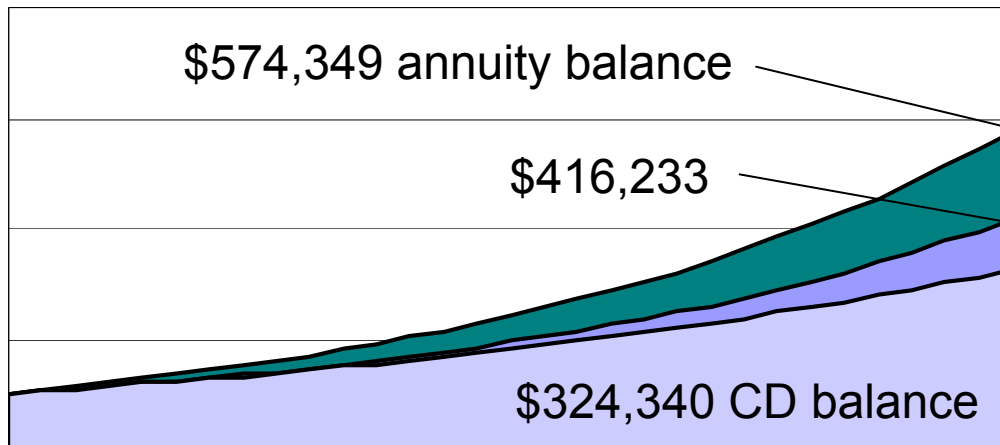


- The power of tax deferral:  
**triple compounding**
- Interest on principal
  - Interest on interest
  - Interest on tax savings



# Non-Qualified Annuities, *continued*

**Tax Deferral**  
really adds up over time . . .



Over 30 years, earning 6% interest and a 33.3% tax rate:

- \$100,000 in a taxable CD results in a \$324,340 balance
- \$100,000 in a fixed annuity results in a \$574,349 balance
- Even if the tax rate is still 33.3% when all the interest is withdrawn in 30 years, the after-tax balance of the annuity is still \$416,233, \$91,893 higher than the CD

# Non-Qualified Annuities, *continued*

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- To encourage using this savings only for retirement, there is a 10% tax penalty on any withdrawal of interest prior to age 59½
- When money is withdrawn from an annuity funded with non-qualified money, only the interest is taxed

# Qualified Annuities

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- The taxation for a qualified annuity is governed by the section of the tax code under which the money is qualified
  - The taxation of IRA money in an annuity, for example, is treated identically to IRA money held in a certificate of deposit in a bank or a mutual fund account

# Qualified Annuities, *continued*

- In general, for IRA's and other forms of qualified money, excluding Roth IRA's:
  - Contributions into the annuity are tax-deductible or are rolled over from an account were they were contributed on a tax-deductible basis
  - Therefore, any withdrawals will be fully taxable as ordinary income
  - Additionally, any withdrawal prior to age 59½ is subject to a 10% penalty tax, unless the withdrawal meets an exception provision in the tax code
  - Distributions of certain minimum amounts must begin no later than April 1 of the year following the year the owner reaches age 70½
    - Failure to take minimum required distributions at that age results in a 50% excise tax on the required amounts that were not distributed

# Qualified Annuities, *continued*

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- In general, for Roth IRA's:
  - Contributions into the annuity are not tax deductible
  - Any withdrawals or annuity payments are non-taxable if they are made after the five taxable year period beginning with the tax year in which the owner first contributed to a Roth IRA, and if they meet at least one of the following requirements:
    - Occur after the owner attains age 59½
    - Occur due to the owner's death
    - Occur while the owner is disabled
    - Are used to pay the costs of a first-time home purchase
  - If a distribution does not meet one of the requirements above, earnings taken in the withdrawal are taxable, and a 10% penalty tax may also apply, with the same exceptions as for a traditional IRA
  - Roth IRA's do not have a minimum required distribution requirement starting at age 70½

# Tax Treatment, *continued*

	Non-qualified	Qualified IRA	Qualified Roth IRA
Contributions	Not tax deductible, unlimited	Tax deductible, limited	Not tax deductible, limited
Interest While Accumulating	<b>Tax deferred</b>	<b>Tax deferred</b>	<b>Tax deferred</b>
Withdrawals	Interest is taxable	Entire amount is taxable	Tax free (if certain rules are met)
Extra considerations before age 59½	10% penalty tax on interest withdrawn	10% penalty tax on entire withdrawal	10% penalty tax on interest withdrawn



## 5. Suitability

# Issue Ages

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- A quick word about issue ages:
- Some carriers set a maximum age above which they will not issue a deferred annuity
  - Why?
  - Regulatory risk: Annuities are given tax-preferential treatment in order to encourage saving for retirement
    - Is a 92-year-old still saving for retirement?
  - Lawsuit risk: Annuities have surrender charges that may exceed a person's life expectancy
    - Is it appropriate to sell an annuity with a 15-year surrender charge to an 87-year-old?
  - Pricing risk: Annuities are backed by long-term bonds, so early deaths pose the risk to insurers that the bonds may need to be sold early to pay death claims

# Suitability Concerns

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- Most agent recommendations of annuity sales are made in the best interest of the client, and the agent adequately explains how the product works to the client
- However, occasional agent misconduct and/or client misunderstanding has brought the industry under increased regulation, bad press, and lawsuits – particularly in regards to consumers age 65 and older
- Examples of abuses:
  - Convincing a client with little investing experience to put money into an account that carries a considerable risk of loss
  - Convincing a client to incur significant surrender charges on an existing account to fund a new account that no better meets his needs
  - Convincing a client to purchase an annuity with a surrender charge that considerably exceeds her remaining life expectancy
  - Convincing a client to put an excessive portion of his financial assets into an annuity, thus leaving him with inadequate liquidity

# Suitability Concerns, *continued*

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- To steer clear of suitability problems, help your client consider these issues:
  
- **Understanding of how the annuity works**
  - Do I have adequate investment and financial experience to understand how the annuity works?
  - Is the amount that I am putting in the annuity typical of the average amount that I place in an investment?
  - If the product has a market value adjustment or other relatively complex features, do I understand how they work?
  - Have I received adequate product descriptions and disclosures?
  - Do I understand that the annuity money is guaranteed by the insurer, and so I have an element of credit risk if the insurer fails?

# Suitability Concerns, *continued*

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- **Maintaining adequate liquidity**
  - Other than those with high net worth or adequate sources of income elsewhere, less than 50% of your financial assets should be in an annuity with surrender charges
  - Do I need the annuity money before the surrender charge period ends or before age 59½?
  - Do I have a need for any of the money within the next year?
    - Most annuities do not have a penalty-free withdrawal amount available in the first year
  - If the annuity is an IRA and I need to take minimum required distributions, would there be any surrender charges associated with those distributions?

# Suitability Concerns, *continued*

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- Income tax considerations
  - To take advantage of the tax deferral offered by annuities, you need to be a taxpayer
    - Many seniors have low incomes and do not pay federal income taxes
  - You should maximize contributions to IRA's, 401(k)'s, and other qualified accounts before purchasing a non-qualified IRA
  - Be aware that annuity interest, when withdrawn, is treated as ordinary income and is not given capital gains treatment
  - Putting IRA money into an annuity does not yield an additional tax benefit, so an annuity should be purchased for its other features and benefits

# Suitability Concerns, *continued*

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- Estate considerations
  - At death, heirs do not receive a step-up in cost basis on an annuity
    - Annuities are subject to income and estate taxes at death
  - If I am relatively healthy and my primary goal is to pass assets to an heir upon death, a life insurance policy, with its income tax-free death benefit, may be better to accomplish that goal than an annuity
  
- General needs
  - Do I want the guarantees afforded by the annuity, since, of course, they do come at a cost?
  - Do my existing accounts or investments achieve my objectives as well as or better than the annuity?



## 6. Paperwork

# Paperwork

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- What forms are typically required to write a fixed annuity?
  
- Most carriers always require:
  - Application
  - Product disclosure
    - Typically a 1 – 4 page document which describes the key policy provisions and which certifies that the owner understands these provisions

# Paperwork, *continued*

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- Premium payment is either:
  - A check payable to the carrier, or
  - A transfer form
    - Transferring qualified money to an annuity
      - Always ask the annuity carrier to get the money directly from the account where the money currently is being held
      - A direct rollover, where the client never takes receipt of the money, is a non-taxable event
    - Transferring existing annuity money to an annuity
      - Always ask the new annuity carrier to get the money directly from the old annuity carrier
      - This event, called a 1035 exchange, is a non-taxable event and preserves the cost basis of the existing annuity

# Paperwork, *continued*

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- Other forms that are sometimes required:
  - Replacement forms, if you are replacing an existing annuity
  - Suitability forms
  - Any other forms that may be required by the carrier or your state

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# Disclaimer

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