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Annuities principles and concepts: Annuities are really savings accounts with the insurance company during the **accumulation phase.** Once an account is annuitized, it becomes an income. Annuitization means the insurance company pays to the annuitant an amount of money in a systematic stream of payments designed to liquidate an estate. A person can choose a fixed option, where all the money is paid out in specified increments or over a specified period of time. A person can also add life to those options. An annuity that is paying for life will continue to pay if they outlive the funds.

We are going to look at annuities now from the perspective of who, what, why, when, how, and where. To sell annuities, you need both a life insurance license and you will need to complete a required one-time 4-hour annuity certification course. This course will count towards your continuing education requirement. To sell variable annuities, you will also need a securities license.

Who are the parties to an annuity? **What** exactly is an annuity? **Why** an annuity? **When** do I put my money in versus when do I take it out? **How** do I get my money in? **Where** do I put my money? **How** do I get my money out?

A. Who are the parties to an annuity? An **Annuity** is a contract between the annuity owner and an insurance company. In a life insurance policy, the parties to the contract are the insurance company, the owner, and the insured — if that is a person other than the owner. *The parties to an annuity then, are the same since both are contracts with an insurance company. They are the owner, the insurance company, the annuitant if they are someone other than the owner, and in some cases, the beneficiary.* A beneficiary has no rights in the contract, cannot make any changes, and only becomes a 'party' in the annuity if the annuitant dies and the beneficiary becomes the annuitant due to the payout option chosen. Since the beneficiary has a right to sue the carrier if the terms are not met, they are considered a party to the contract.

B. What is an annuity? It is a legal contract between a person and an insurance company. An annuity is a savings plan that will pay out to the annuitant over a period of time or for the rest of his or her life, according to the payout option the owner has chosen. ***An annuity contract is different from a life insurance contract in that the purpose of an annuity is to provide an income to an individual (a.k.a. the annuitant) while he is alive, whereas a life insurance contract pays a death benefit to a beneficiary when the individual dies. Simply put, life insurance creates an estate, an annuity liquidates an estate in a systematic stream of payments.*** The payments made to the deferred annuity are called premiums.

C. What are the uses of an annuity? An annuity is designed to systematically liquidate an estate in a stream of payments. These could be over a designated period of time or in a certain amount. There are many uses for this, including retirement. Other examples include leaving money to a child with a disability and an annuitant does not want to risk them being taken advantage of. If we tie the money up in an annuity, it will be paid to them as a stream of payments and the principal is not available to cash out if they have chosen a life option. Budgeting is not everyone's strength, having a lump sum settlement paid out monthly can be quite useful for the consumer.

1. **Lump sum**. If you were to receive a lump sum settlement, an inheritance, win at the casino, etc., there are ways to save some or all of it for later. In an annuity account that grows tax deferred, that has no limits on how much an annuitant can put in it, and no rules on taking it out at any age. Unless an annuitant chooses an immediate annuity, their money is harder to take out due to a back-end sales charge — a fee for taking it out for a few (up to 10) years.

2. **Retirement income**. If you are ready to retire and want a regular check every month as you have always had, you could buy an annuity and choose a life option. You can roll over your IRA or your 401K into an annuity and the carrier will send a monthly check. You will never run out of income. If you are not yet ready to retire.

D. What are some riders to an annuity?

A company offering annuities may have many riders that may be added to your plan. Each of these will have a fee. They range from a Cost-of-Living Rider to Guaranteed Minimum Income. A Long-Term Care rider may be added which may increase the payment if needed for Long-Term Care costs.

1. **Long-Term Care Rider** is a rider that covers long-term care according to the amounts in the contract. It is paid for with a lump sum so, unlike a Long-Term Care policy, the premiums cannot increase. You may be able to access the benefit immediately. Conversely, if you do not use the benefit the money is still there and can be passed down to an heir or beneficiary. You do need to qualify medically for the rider, and it is limited to a payout of a certain number of years. The payout can be your standard expected annuity payout with a multiple of 2 or 3 for up to 5 years.

2. **Guaranteed Minimum Income Benefit** is a rider that guarantees a minimum payment, as the name suggests. This could be important in a volatile market with a variable annuity. If a person is counting on a certain amount to cover expenses, they can purchase this rider to be certain they will receive at least that amount of income. This is used after the annuity has been annuitized and is making payments. This rider comes with a fee.

3. **Guaranteed Minimum Withdrawal Benefit (GMWB)** is a rider that allows you to withdraw a portion of your investment annually. Most annuities have that in place already, up to 10% of the investment amount annually. This rider guarantees the initial principal investment may be withdrawn over a number of years, even if the market has lowered the value of the account.

Withdrawing is different from receiving the annuitization or income. Once an annuity has been annuitized the control is turned over to the insurance company and they make systematic income payments to the annuitant.

Instead of annuitizing, a person may decide to withdraw a portion of the funds annually. In a volatile market, the value of the account could easily drop. This rider protects the client by guaranteeing that whatever the value is, the total amount that can be withdrawn will be equal to or greater than the amount in the account at the time of purchase.

It can be in addition to the income an annuity offers. The reason for this rider is if you were to withdraw 10% of the initial investment but the market had dropped, the investment has also dropped the 10% figure also is lower than it could be.

E. Why choose an annuity?

- The ***interest is earned tax-deferred until withdrawn.***

* There are no limits as to how much an annuitant can put in there. There are no contribution limits other than what limits the investment / insurance company has.

  - *A qualified retirement plan also has tax-deferred growth and may be funded with pretax dollars. However, there are requirements and limits. There will be an annual limit, the money must be earned income and the required minimum distribution must start no later than the year you turn 72.*

* There are no requirements to take it out, ever.

* It's not for everyone due to the fees, but if an annuitant has money to invest and their IRA and employee benefit plans are at the maximum, this type of plan is perfect for long-term savings.

* It is the annuitant's money, and they may access it at any time.

* If money is withdrawn from an annuity, **interest accumulation is withdrawn first,** meaning it is taxed as it comes out and only that taxable amount is subject to a 10% penalty**. * There is a 10% *early withdrawal penalty* on the earned interest if the money is withdrawn before age 59½.** The owner is fully vested, and she controls her money.

  - ** The only exception is if the annuitant has chosen a life option at the contract date. The money is not accessible to the annuitant until payout. The contract may not be surrendered.

- Lump sum settlements that an annuitant may not need access to immediately can grow tax deferred and be paid in an installment option.
- Will an annuitant outlive their retirement savings? Not if they pick a Life payout option.

F. When do I put it in versus when do I take it out? There are two time periods tied to an annuity: the **accumulation phase** when an annuitant is putting money into the account or letting it grow *(known as a <u>deferred annuity</u>)* and the **liquidation or payout phase** when an annuitant is receiving benefits, known as the **annuitization phase**. *(This starting point is the annuitization date and the account may be known as an <u>immediate annuity</u>.)* The payout or liquidation phase is when the annuity begins to generate regular income payments to the annuitant.

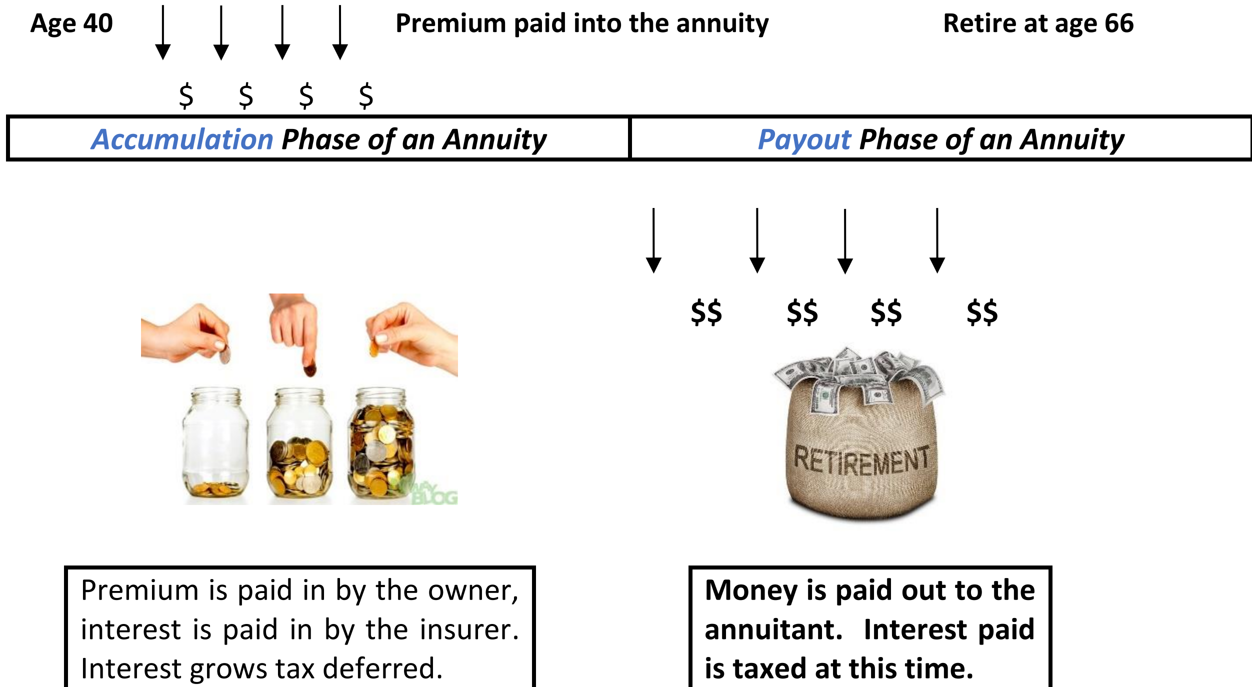
Annuity Phases

From the opening of the account to the withdrawal time, how much time has passed?

a) Immediate Annuity (a.k.a. The **Payout or Liquidation Phase**) — An annuity where income payouts are to begin soon after the contract is purchased, which must be in one year or less. Immediate annuity contracts are paid for (purchased) with a lump sum. Why a year? In choosing a payout option you also specify how often you want those payments made; monthly, quarterly, semi-annual, or annually. Therefore, if you purchase an annuity and request annual payments, your first payment is in one year.

b) Deferred Annuity (a.k.a. The **Accumulation Phase**) — An annuity where payments to the annuitant are delayed or deferred from the date of the contract until some future date (usually retirement). You may pay for these with a lump sum, a fixed payment plan, a flexible payment plan, or a combination. ($5000 down and $300 monthly payments.)

- You never actually have to annuitize an annuity. Many annuities have withdrawal options where you, the account owner, withdraw a certain amount or percent each year without annuitizing the account.



G. How do I get my money in?

1. **Single Payment**, a.k.a. **Lump Sum…** the annuity is purchased with a single premium payment or a lump-sum payment. The annuity is paid in full. This is required for immediate annuities.

2. **Level/Fixed Installment…** the annuity is purchased in equal payments at regular intervals over a deferral period.

3. **Flexible Premium Payments…** the annuity is purchased allowing the owner of the contract to vary premium payments from year to year.

- A combination of all the above. *E.g., $5,000 down with $300 per month but you may drop in extra anytime.*

4. What happens if I stop paying? This plan is a savings plan during the accumulation period. If you stop paying in, the carrier does not keep the money. Similar to the nonforfeiture options in a whole life policy you have choices. The owner will Not Forfeit or lose the funds already accumulated. The money can remain in the account growing tax deferred, you can withdraw all or some of it — fees will apply — a.k.a. a total or partial surrender, or you can annuitize the account. Annuitizing will not incur any fees.

What sorts of fees? They are built into the plan. Because the plan is intended to be long term there is generally a Contingent Defered Sales Charge (CDSC). If you withdraw any funds during the first year, you may end up paying 10% in fees to the carrier. The second year the fee will be 9%, etc. until after 10 years the fees have vanished. These are insurance company fees, if you withdraw any money before age 59 ½ the IRS also want taxes on the portion that has been growing tax deferred that is taken out as well as a 10% pealty.

H. Where do I put my money?

1. **A Fixed annuity** has a ***fixed guaranteed*** rate of return; however, some may pay more than the stated guaranteed amount (current assumption). Under current assumption contracts, the *guarantee* (usually between 3 and 5%) is combined with the *excess* interest credited to the cash. This is called the *current* rate of interest. The excess interest is NOT guaranteed.

2. **An (Equity) Index annuity** is a ***hybrid product*** that offers guaranteed principal, a minimum guaranteed return (such as 1%), and the opportunity to participate in the ***upside potential of the equity markets*** by using indices such as the Standard & Poor's 500.

   - If the index return is flat, the principal is guaranteed as well as a minimum rate of return.
   - If the index drops the principal is guaranteed as well as a minimum rate of return.
   - If the index rises? There is a higher rate of return, and the principal is still guaranteed.

   An Index Annuity can use two or more indices for funding the Annuity. They first came to the market in 1995 and have been sold as insurance, without SEC or FINRA supervision, meaning you do not need a securities license to sell this product.

3. **A Variable annuity** is a securities product because the investment return depends on the performance of the separate account. A securities license is required to sell these, the annuitant assumes the investment risk, and there is ***no guarantee*** on the increase in value of the contract. The cash value will go up with the stock market gain but will also go down with a decrease in the stock market.

- Accumulation units are purchased, and annuity units are paid out.

- An interesting feature of variable annuities is if you annuitize the account after the market has dropped you will be paid out based on the current balance. However, if the market drops and the value of the account drops and the annuitant dies PRIOR to annuitizing the account, the beneficiary receives the higher value of the annuity at the time of death or the value of the annuity at the last anniversary date. This is a death benefit paid out and is one of the many costs associated with this product.

I. How do I get my money out? Life Payout (Settlement) Options vs. Certain Payout (Settlement) Options

Unless or until an annuitant chooses a life option, they can take out the money at any time**. You are always fully vested and may withdraw at any time. This is known as the Nonforfeiture value.** It is the balance of the account available to the owner. It is the premiums paid + interest – surrender charges (if applicable) – any prior withdrawals. Any money withdrawn comes out of the interest first which is taxable. If the client is not yet 59 ½ there is also a 10% penalty tax on the taxable portion of the withdrawal. A person may purchase an annuity and not choose a payout option until they are ready, or they may choose the option immediately.

Annuities have a Contingent Deferred Sales Charge (CDSC) which usually runs for 8 years. If you withdraw (partial surrender) funds during the first year there is an 8% sales charge, if you withdraw (partial surrender) funds during the second year there is a 7% sales charge, as the years increase the sales charge decreases until; it is eliminated. Annuities are meant to be long-term policies.

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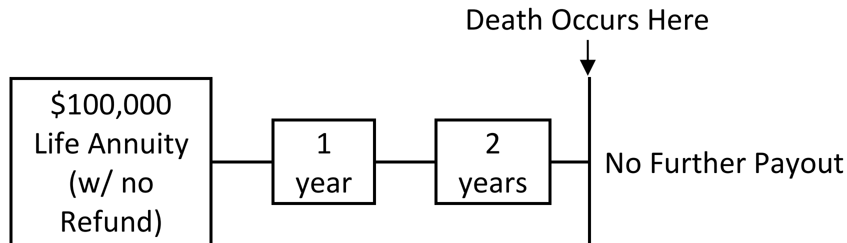
1. Life Annuity Options — the payout amount is determined by the annuitant's age, gender and option chosen. **Life annuities are ideal for retirement because their primary purpose is to provide an income that cannot be outlived**. Once the annuity payouts start, the insurance company guarantees that the payments will continue no matter how long the annuitant lives, thus giving a true lifetime guarantee of income. **Keep in mind that once a Life option is chosen, it cannot be canceled or surrendered.** Life options will continue to pay out the amount in the contract even if the account is down to zero, as long as the annuitant is alive it pays.

***There are five life options*:**

If the word **LIFE is used, the annuitant is paid for **LIFE,** regardless of how long they live. A beneficiary only becomes part of the contract and is paid if the annuitant dies either prior to the balance of the principal being paid out or the annuitant dies prior to a period of time passing.

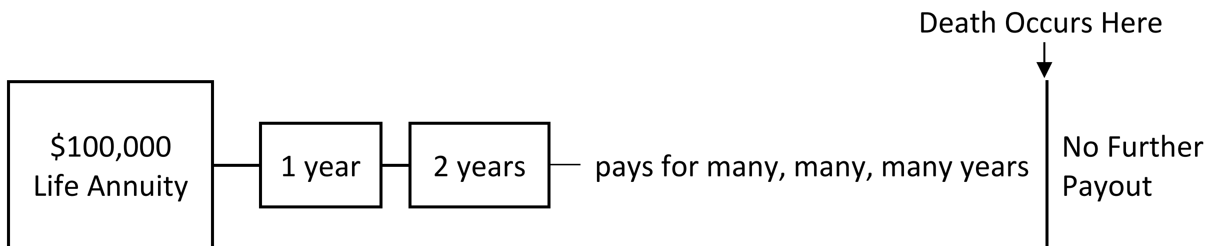
The first 3 life options are for individuals, 2 of the 3 have a beneficiary for either the money left in the account if the annuitant dies before all the money paid in has been paid out, or a period of time of payments should the annuitant die before a specified period of time has passed. The last 2 options are joint and are for 2 people.

a) **Life (Straight/Pure) w/No Refund** is one where the annuitant receives a specified amount for as long as he/she lives. The insurance company's obligation ends upon death. There is no beneficiary.

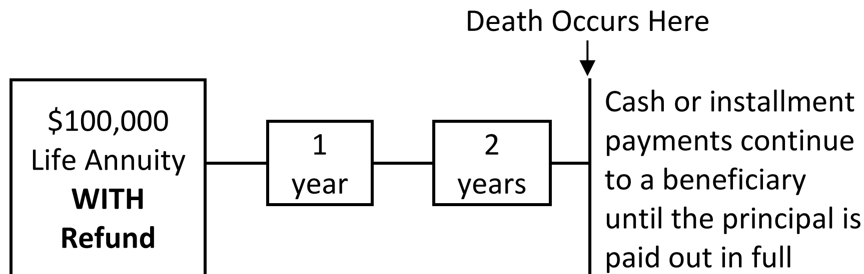


That scenario looks great for the insurance company but not so great for our client. This option however has the highest payout of all the options. Of course, if our client lives for 40 years, this will pay for 40 years.

Life (Straight/Pure) w/No Refund cont.:



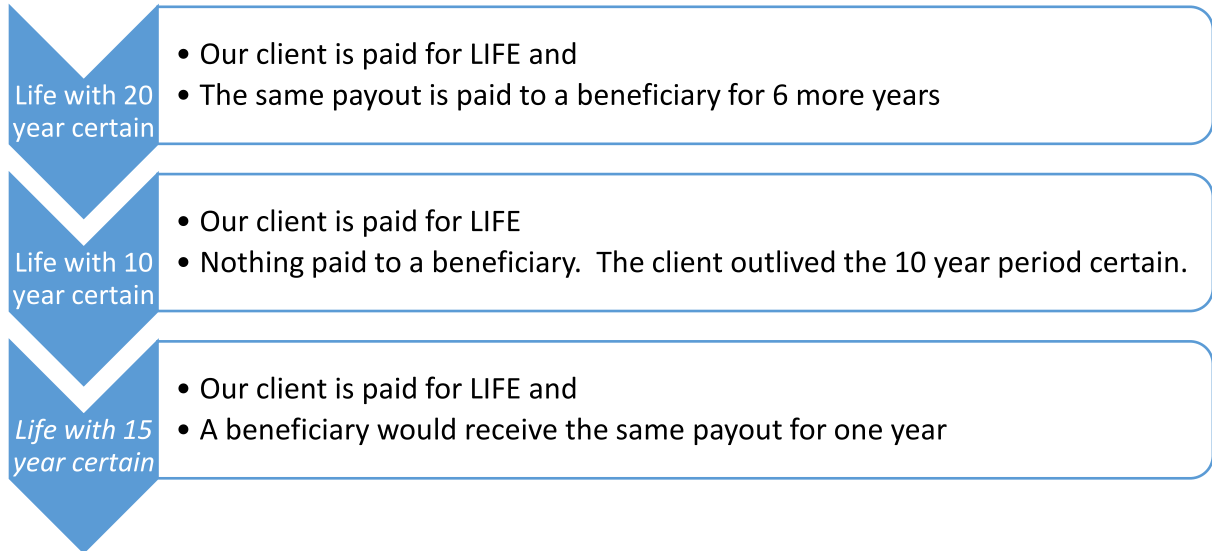
b) **Life with Refund** provides income to the annuitant for life and payment to the ***beneficiary*** if the annuitant dies prior to receiving an amount equal to the full amount paid for the annuity (a.k.a. principal).



- a.k.a. ***Cash Refund*** or ***Installment Refund Annuity***

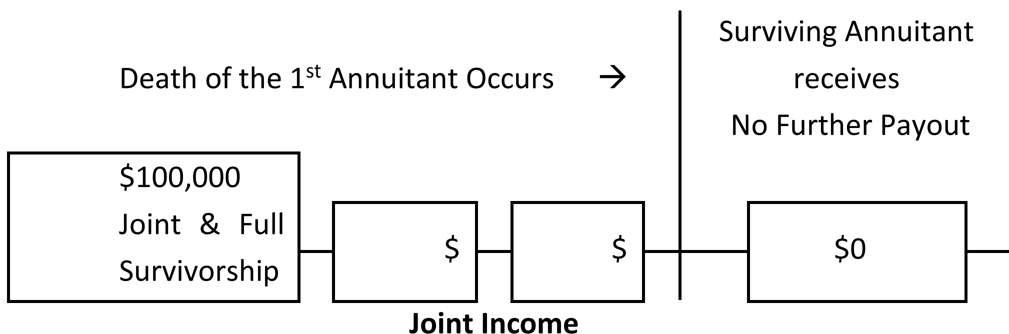
Although it is named "Life with refund," "Cash refund," or "Installment refund," think of it as life OR refund. This will pay the annuitant for life OR it will pay a beneficiary through the balance of the principal. ***Whichever pays out more***.

c) **Life w/ Period Certain** provides a life income for the annuitant. If the annuitant dies within a specified period (such as 5, 10, or 20 years), the same annuity payments will continue to the named ***beneficiary*** until the end of the stated period.

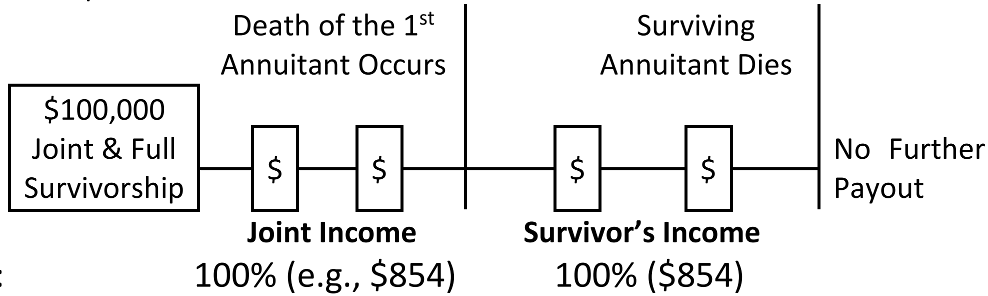


Although it is named "Life with Period certain," think of it as life OR period certain. Replace a number for the word 'period.' life with 10-year certain for example. This will pay the annuitant for life OR it will pay a beneficiary through the end of the certain period of time**.** ***Whichever pays out longer*.**

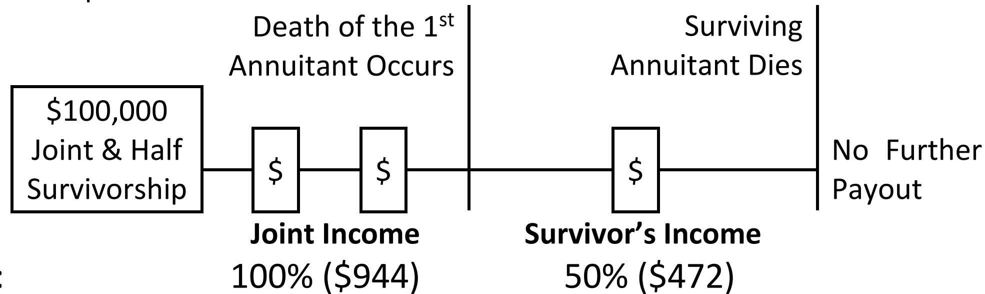
d) **Joint Life Annuity** pays an income to two annuitants (with one check) and terminates when the first annuitant dies. There is no beneficiary. This is a very risky option if this is to be the only income. It has the higher payout amount of the two joint options.



e) **Joint Life w/ Survivorship** pays an income to two annuitants (with one check) but will continue to pay the second annuitant when the first annuitant dies. The annuitant chooses the amount of the continued payout, such as 1/2, 2/3, etc., of the original payout, at the time the annuity contract is purchased. However, **when the survivor (annuitant) dies, all payouts stop.** The survivor is not a beneficiary, they are an annuitant.



Payments: 100% (e.g., $854) 100% ($854)



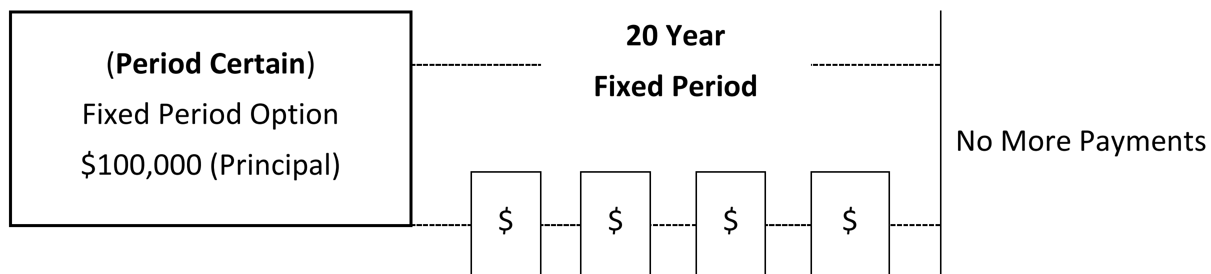
Payments: 100% ($944) 50% ($472)

The difference is the 100% with full survivorship will be a lower amount than 100% with partial survivorship for the same investment. Less later = More now.

Payout amounts are determined by the average age, sex, amount invested, and which option is chosen.

2. Annuity Certain Options (Fixed)… The fixed option ***guarantees*** the payout of all the principal and interest and allows the annuity owner to cash out the contract. ***The negative aspect of the fixed option is that the annuitant could outlive the annuity.***

a) The Fixed Time Annuity payout option ***guarantees*** all of the principal plus interest to the annuitant ***over a period of time*** (a.k.a. Period Certain). **The annuitant could, however, outlive the annuity payout.**



✓ This option will pay equal installments of an amount that will exhaust the principal and interest during the fixed period (i.e., 20 years). If the annuitant dies before the 20 years is over, the ***beneficiary*** will receive the same installments for the balance of the 20 years.

b) Fixed Amount Annuity… Under this settlement option, the annuitant receives benefit payments of a ***set amount*** for as long as the ***annuity's accumulation value plus interest lasts.*** If Ms. B has an accumulation value of $200,000, under this settlement option, she could elect to receive a monthly benefit payment of $3000 (or any other amount she prefers). The insurance company would send her a check each month for as long as the accumulation value and interest would support the benefit. After the funds in the annuity were exhausted, Ms. B would not receive any further benefits from the annuity contract. In the event of Ms. B's death before the funds in the annuity have been used up, the remainder generally is paid to her ***beneficiary***.

The following are 2 different review charts to do a quick study on annuities.

Is there a Beneficiary?	Annuity Payout Options	Pays for…	When the annuitant dies, the beneficiary is paid…
Yes	**Fixed Time a.k.a. period certain**	A fixed period of time *(e.g., 10 or 20 years)*	Through the time listed on the contract
Yes	**Fixed Amount**	Until the money's gone (principal + interest) *(e.g., $3000/month)*	Until the money has been paid out
No	**Life**	Life	**Nothing.**
Yes	**Life with Refund**	Life to annuitant	The remaining balance of principal if any
Yes	**Life with Period Certain**	Life to annuitant	Until the period of time has ended if the annuitant dies prior to the end of that named time *(e.g., 10 or 20 years)*
No	**Joint**	Life	*No Beneficiary.* The 2nd Annuitant gets **Nothing.**
No	**Joint Survivor**	Life	*No Beneficiary.* The 2nd Annuitant is paid for life.

The 2 fixed options will pay equal installments of both principal and interest until the funds are all paid out. This will not cause an annuitant to have any income tax until the last year. Remember, interest grows tax-deferred, so it will be taxed on withdrawal.

Life with refund or life with period certain are 2 ways to make sure a beneficiary will receive money whether it is until the balance of principal is paid, either in a lump sum or an installment option for refund, or a period of time is met.

Joint with Survivor could pay the survivor the full amount, 2/3 of the initial amount, 1/2 the initial amount, or whatever the client feels will be needed. The survivor is an annuitant, *not a beneficiary,* so they will be paid for life.

BUILD YOUR ANNUITY — CHOOSE ONE OF EACH OPTION

Premiums Paid

- Single Premium
- Fixed Premium
- Flexible Premium

Investment Options

- Fixed (Guaranteed)
- Variable
- Equity Index

Payout Begins

- Immediate
- Deferred

Fixed Payout Options

- Fixed Guaranteed Time
  a.k.a. Period Certain
- Fixed Guaranteed Amount

Life Payout Options

- Life / Straight / Pure / No Refund
- Life w/ Period Certain
- Life w/ Refund
  - Cash or Lump Sum Refund
  - Installment Refund
- Joint Life
- Joint Life w/ Survivorship