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WA Annuity Suitability with Best Interest Standards of Conduct #629634 4 Hour Course

Washington State Insurance

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Annuity Suitability with Best Interest Standards

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Introduction to Annuities

Annuities ... An **annuity** is a contract between an annuitant and an insurance company which calls for a systematic liquidation of an estate. By liquidation we mean to convert an estate into a ***systematic stream of cash payments***. The person who receives these payments is called an **annuitant.**

1. When Do Benefits Begin?

Immediate Annuity … one where income payouts are to begin soon after the contract is purchased. Immediate annuity contracts are paid for with a lump sum.

Deferred Annuity … one where payouts to the annuitant are delayed or deferred from the date of the contract until some future date (usually retirement). The payments made to the deferred annuity are called premiums (a.k.a. the ***accumulation phase).***

- The interest earned on a deferred annuity is tax-deferred (until withdrawn). However, there is a 10% *early withdrawal penalty charged by the IRS* on the earned interest if the money is withdrawn before age 59½ (some exceptions do apply). If money is withdrawn from an annuity, *interest accumulation is withdrawn first*.

2. Different Ways to Fund A Deferred Annuity

- **Single,** a.k.a. **Lump Sum …** where the annuity is purchased with a single premium payment or lump-sum. The annuity is paid in full.
- **Level/Fixed Installment …** where the annuity is purchased in equal payments at regular intervals over a deferral period.
- **Flexible Premium Payments …** where the annuity is purchased by allowing the owner of the contract to vary premium payments from year to year.

3. Fixed vs. Index vs. Variable Annuities

- **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.
- **An index annuity** is a ***hybrid product*** that offers 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. 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.
- **A variable annuity** is a securities product because the investment return depends on the performance of that 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.

4. **Payout (Settlement) Options of Immediate Annuities**

Life Annuity Options vs. Annuity Certain Options

Life Annuity Options … the payout amounts will be determined by the annuitant's age, gender and option chosen. Some insurance companies do not allow life options to be surrendered after the contract is purchased.

Life Annuities are ideal for retirement because their primary purpose is to provide an income you cannot outlive. Once a life annuity payout (liquidation) begins, the insurance company guarantees that the payment will continue no matter how long the annuitant lives…a true "***lifetime guarantee***".

There are five life options:

1) **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.

2) **Life w/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 (a.k.a. Principal) for the annuity. a.k.a. ***Cash Refund*** or ***Installment Refund Annuity***

3) **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.

4) **Joint Life Annuity** pays an income to two annuitants (with one check) and terminates when the first annuitant dies. There is no beneficiary.

5) **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.

Annuity Certain Options (Fixed) … The fixed option ***guarantees*** 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.***

1) The ***Fixed Time Annuity*** **…** under this settlement option, the annuitant is *guaranteed* all of the principal plus interest ***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.

2) ***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.***

5. Uses of Annuities include:

Retirement Funding (by far the most common purpose)

Settlements

College Tuition

Estate Tax Planning

Long-Term Care

Business Planning

Section I – Pre-License Education

WAC 284-17-265 Sales of Annuities and Insurance Producer Training

A person may not sell, solicit, or negotiate the sale of an annuity product unless he or she is appropriately licensed as an insurance producer and has successfully completed the annuity suitability training that meets the requirements of this section.

- After March 29, 2012, prior to selling, soliciting, or negotiating the sale of annuity products, all insurance producers must complete a *one-time*, **four-hour training course** approved by the commissioner and provided by an insurance education provider approved in this state.
    - Each insurer that has annuity products approved for sale in this state must:
- Certify that each of the insurers' producers currently engaged in the sale, solicitation, or negotiation of the sale of annuity products has completed the required training of this section.
- Persons who obtain a life insurance producer license on or after March 29, 2012, may not sell, solicit, or negotiate the sale of an annuity until the annuity training course has been completed.
- Effective January 1, 2024 any person who sells annuities must complete a 1 hour additional Best Interest Standards course no later than June 30th.
- All new licensees will complete the revised 4 hour annuity course that includes Vest Interest.
- All licensees who do not complete the additional 1 hour course by June 30th will need to take the revised 4 hour course.

The ***annuity suitability training*** required under this section must include:

- The types of annuities and various classifications of annuities;
- Identification of the parties to an annuity;
- How fixed, variable, and indexed annuity contract provisions affect consumers;
- The application of income taxation of qualified and nonqualified annuities;
- The primary uses of annuities; and
- Appropriate sales practices, replacement of an annuity, and disclosure requirements.

The training required in this section must:

- be sufficient to qualify for at ***least four continuing education credits;***
- be completed by either classroom instruction or self-study;
- not include training that is issuer or company product specific or includes any sales or marketing information and materials; and
- be provided by an approved provider who must administer the course, issue certificates of completion, report completed training to the commissioner, and maintain records as required by **WAC 284-17-270 through 284-17-310**.

Section II – Suitability in Annuity Transactions

WAC 284-23-390 Duties of Insurers and Insurance Producers.

1) For purposes of this section, "***suitability information***" means information that is reasonably appropriate to determine the suitability of a recommendation, including the following:

- Age
- Annual income
- Financial situation and needs, including the financial resources used for the funding of the annuity
- Financial experience
- Financial objectives
- Intended use of the annuity
- Financial time horizon
- Existing assets, including investment and life insurance holdings
- Liquidity needs
- Liquid net worth
- Risk tolerance
- Tax status

2) In addition to the requirements in RCW 48.23.015, insurers and insurance producers must have reasonable grounds to believe the following requirements in recommending and executing a purchase or exchange of an annuity:

- The consumer has been reasonably informed of the features of the annuity, such as the potential surrender period and surrender charge, **potential tax penalty** if the consumer sells, exchanges, surrenders or annuitizes the annuity, mortality and expense fees, *investment advisory fees, charges for and features of riders, limitations on interest returns, insurance and investment components, and market risk.*

- **The consumer would benefit from certain features of the annuity, such as tax deferred growth, annuitization, or death or living benefit.**

- The particular annuity as a whole, the underlying subaccounts to which funds are allocated at the time of purchase or exchange of the annuity, and riders and similar product enhancements, if any, are suitable (and in the case of an exchange or replacement, the transaction as a whole is suitable) for the particular consumer based on his or her suitability information.

RCW 48.23.015

Purchase or Exchange of Annuities — Definitions — Standards — Requirements — Conduct — Records — Penalties — Rules.

1) For the purposes of this section:

"Annuity" means a fixed annuity or variable annuity that is individually solicited, whether the product is classified as an individual or group annuity.

"Recommendation" means advice provided by an insurance producer, or an insurer when no producer is involved, to an individual consumer that results in a purchase or exchange of an annuity in accordance with that advice.

2) Insurers and insurance producers must comply with the following requirements in recommending and executing a purchase or exchange of an annuity:

a) In recommending the purchase of an annuity or the exchange of an annuity that results in another insurance transaction or series of insurance transactions to a consumer, the insurance producer, or the insurer when no producer is involved, must have reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer about their investments and other insurance products and as to their financial situation and needs.

b) Prior to the execution of a purchase or exchange of an annuity resulting from a recommendation, an insurance producer, or an insurer when no producer is involved, shall make reasonable efforts to obtain information concerning:

- **The consumer's financial status**
- **The consumer's tax status**
- **The consumer's investment objectives**
- **Information used by the insurance producer**, or the insurer when no producer is involved, in making recommendations to the consumer

3) An insurer or insurance producer's recommendation must be reasonable under all circumstances actually known to the insurer or insurance producer at the time of the recommendation. Neither an insurance producer nor an insurer when no producer is involved, has any obligation to a consumer related to any recommendation if a consumer:

- Refuses to provide relevant information requested by the insurer or 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.

4) An insurer must assure that a system to supervise recommendations, reasonably designed to achieve compliance with this section, is established and maintained. The system must include, but is not limited to, written procedures and conducting periodic review of its records that are reasonably designed to assist in detecting and preventing violations of this section.

a) *An insurer may contract with a third party, including insurance producers, a general agent, or independent agency, to establish and maintain a system of supervision as required in this subsection With respect to insurance producers under contract with or employed by the third party*. An insurer must make reasonable inquiry to assure that the third party is performing the functions required in this subsection and must take action as is reasonable under the circumstances to enforce the contractual obligation to perform the functions. An insurer may comply with its obligation to make reasonable inquiry by doing all of the following:

i) Annually obtaining a certification from a third party senior manager with responsibility for the delegated functions that the manager has a reasonable basis to represent that the third party is performing the required functions; and

ii) Based on reasonable selection criteria, periodically selecting third parties contracting under this subsection for a review to determine whether the third parties are performing the required functions. The insurer shall perform those procedures to conduct the reviews that are reasonable under the circumstances.

b) An insurer, or the contracted third party if a general agent or independent agency, is not required to:

i) Review, or provide for review of, all insurance producer solicited transactions; or

ii) Include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer, general agent, or independent agency.

c) ***A general agent or independent agency contracting with an insurer to supervise compliance with this section shall promptly, when requested by the insurer, give a certification of compliance or give a clear statement that it is unable to meet the certification criteria***. A person may not provide a certification unless the person:

i) Is a senior manager with responsibility for the delegated functions; and

ii) Has a reasonable basis for making the certification.

5) **Compliance** with the **Financial Industry Regulatory Authority** conduct rules pertaining to suitability satisfies the requirements under this section for the recommendation of annuities registered under the securities act of 1933 (15 U.S.C. Sec. 77(a) et seq. or as hereafter amended). The insurance commissioner must notify the appropriate committees of the house of representatives and senate if there are changes regarding the registration of annuities under the **Securities Act of 1933** that affect the application of this subsection. This subsection does not limit the insurance commissioner's ability to enforce this section.

6) The **commissioner may order** an insurer, an insurance producer, or both, to take reasonably appropriate corrective action for any consumer harmed by the insurer's or insurance producer's violation of this section. Any applicable penalty under this or other sections of insurance code may be reduced or eliminated by the commissioner if corrective action for the consumer was taken promptly after a violation was discovered.

7**)** Insurers and insurance producers must maintain or be able to make available to the commissioner records of the information collected from the consumer and other information used in making the recommendations that were the basis for the insurance transaction for five years after the insurance transaction is completed by the insurer, or for five years after the annuity begins paying benefits, whichever is longer. An insurer is permitted, but is not required, to maintain documentation on behalf of an insurance producer. This section does not relieve an insurance producer of the obligation to maintain records of insurance transactions as required by RCW 48.17.470.

8) In the case of an **exchange or replacement of an annuity**, the exchange or replacement is suitable including taking into consideration whether:

- The consumer will incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living or other contractual benefits), or be subject to increased fees, investment advisory fees or charges for riders, and similar product enhancements;

- The consumer would benefit from product enhancements and improvements; and

- The consumer has had another annuity exchange or replacement and, in particular, an exchange or replacement within the preceding thirty-six months.

9) Prior to the execution of a purchase, exchange or replacement of an annuity resulting from a recommendation, an insurance producer, or an insurer where no producer is involved, shall make reasonable efforts to obtain the consumer's suitability information.

10) An insurer shall not issue an annuity recommended to a consumer unless there is a basis to believe the annuity is suitable based on the consumer's suitability information.

11) An insurer's issuance of an annuity must be reasonable under all the circumstances actually known to the insurer at the time the annuity is issued.

12) An insurance producer or, where no insurance producer is involved, the responsible insurer representative must at the time of sale:

- *Make a record of any recommendation subject to this section;*
- *Obtain a customer signed statement documenting a customer's refusal to provide suitability information, if any; and*
- *Obtain a customer signed statement acknowledging that an annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the insurance producer's or insurer's recommendation.*

13) In addition to the requirements in RCW 48.23.015(4) an insurance company must:

- Maintain reasonable procedures to inform its insurance producers of the requirements of this regulation and shall incorporate the requirements of this regulation into relevant insurance producer training manuals;
- Establish standards for insurance producer product training and must maintain reasonable procedures to require its insurance producers to comply with the requirements of WAC 284-17-265;
- Provide product-specific training and training materials which explain all material features of its annuity products to its insurance producers;
- Maintain procedures for review of each recommendation prior to issuance of an annuity that are designed to ensure that there is a reasonable basis to determine that a recommendation is suitable. Such review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;
- Maintain reasonable procedures to detect recommendations that are not suitable. This may include, but is not limited to, on confirmation of consumer suitability information, systematic customer surveys, interviews, confirmation letters and programs of internal monitoring; and
- Annually provide a report to senior management, including to the senior manager responsible for audit functions, which details the review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any.

14) An insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with of this subsection.

RCW 48.23.015(4)

An insurer must assure that a system to supervise recommendations, reasonably designed to achieve compliance with this section, is established and maintained. The system must include, but is not limited to, written procedures and conducting periodic review of its records that are reasonably designed to assist in detecting and preventing violations of this section.

a) An insurer may contract with a third party, including insurance producers, a general agent, or independent agency, to establish and maintain a system of supervision as required in this subsection with respect to insurance producers under contract with or employed by the third party. An insurer must make reasonable inquiry to assure that the third party is performing the functions required in this subsection and must take action as is reasonable under the circumstances to enforce the contractual obligation to perform the functions. An insurer may comply with its obligation to make reasonable inquiry by doing all of the following:

i) Annually obtaining a certification from a third party senior manager with responsibility for the delegated functions that the manager has a reasonable basis to represent, and does represent, that the third party is performing the required functions; and

ii) Based on reasonable selection criteria, periodically selecting third parties contracting under this subsection for a review to determine whether the third parties are performing the required functions. The insurer shall perform those procedures to conduct the review that are reasonable under the circumstances.

b) An insurer, or the contracted third party if a general agent or independent agency, is not required to:

1) review, or provide for review of, all insurance producer solicited transactions;
2) include in its system of supervision an insurance producer's recommendations to consumers of products other than the annuities offered by the insurer, general agent, or independent agency.

c) A general agent or independent agency contracting with an insurer to supervise compliance with this section shall promptly, when requested by the insurer, give a certification of compliance or give a clear statement that it is unable to meet the certification criteria. A person may not provide a certification unless the person is a senior manager with responsibility for the delegated functions; and has a reasonable basis for making the certification.

15) An insurer's supervision system must include supervision of contractual performance under this subsection. This includes, but is not limited to, the following:

- Monitoring and, as appropriate, conducting audits to assure that the contracted function is properly performed; and
- Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

16) An insurance producer may not dissuade, or attempt to dissuade, a consumer from:

- ***Truthfully responding to an insurer's request for confirmation of suitability information***
- ***Filing a complaint***
- ***Cooperating with the investigation of a complaint***

Section III – Best Interest Standards

Best Interest Standard of Conduct

The purpose of this regulation is to protect the consumer by having minimum standards regarding disclosures and ensuring some education regarding the products they are purchasing. The goal is to help the consumer understand what they have and what the costs associated with it are. Not all annuities are covered by this regulation.

This regulation is for retail sales, all group and individual annuity contracts and certificates **except:**

- Annuities with no non-guaranteed elements
- Annuities used to fund
  - An employee pension plan (covered by ERISA)
  - Employer-sponsored plans; 401k, 401a, 403b
  - Governmental plan or church plans sec 414
  - Deferred compensation plans defined under sec 457 of the IRC for state or local governments
  - Non-qualified deferred compensation plans established or maintained by an employer or plan sponsor
- Non-registered variable annuities issued exclusively to an accredited investor or qualified purchaser as those terms are defined by the Securities Act of 1933
  - Variable annuities and other registered products must use a buyer's guide as required but the disclosures and illustration requirements are met by the requirements from the SEC and FINRA
- The commissioner may require additional disclosures.
- Structured annuity settlements
- Charitable gift annuities
- Funding agreements

https://www.govinfo.gov/content/pkg/CFR-2022-title17-vol4/pdf/CFR-2022-title17-vol4-sec240-15l-1.pdf

§ 240.15l–1 Regulation best interest. (a) Best interest obligation.

(1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer, shall act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer.

(2) The best interest obligation in paragraph (a)(1) of this section shall be satisfied if:

(i) Disclosure obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of the recommendation, provides the retail customer, in writing, full and fair disclosure of:

(A) All material facts relating to the scope and terms of the relationship with the retail customer, including:

(1) That the broker, dealer, or such natural person is acting as a broker, dealer, or an associated person of a broker or dealer with respect to the recommendation;

(2) The material fees and costs that apply to the retail customer's transactions, holdings, and accounts; and

(3) The type and scope of services provided to the retail customer, including any material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer; and

(B) All material facts relating to conflicts of interest that are associated with the recommendation.

(ii) Care obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation, exercises reasonable diligence, care, and skill to:

(A) Understand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

(B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's

investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer.

(iii) Conflict of interest obligation. The broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to:

(A) Identify and at a minimum disclose, in accordance with paragraph (a)(2)(i) of this section, or eliminate, all conflicts of interest associated with such recommendations;

(B) Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for a natural person who is an associated person of a broker or dealer to place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer;

(C)(1) Identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, in accordance with subparagraph (a)(2)(i), and

(2) Prevent such limitations and associated conflicts of interest from causing the broker, dealer, or a natural person who is an associated person of the broker or dealer to make recommendations that place the interest of the broker, dealer, or such natural person ahead of the interest of the retail customer; and

(D) Identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

(iv) Compliance obligation. In addition to the policies and procedures required by paragraph (a)(2)(iii) of this section, the broker or dealer establishes, maintains, and enforces written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf

33318 Federal Register / Vol. 84, No. 134 / Friday, July 12, 2019 / Rules and Regulations SECURITIES AND EXCHANGE COMMISSION 17 CFR Part 240 [Release No. 34–86031; File No. S7–07–18] RIN 3235–AM35 Regulation Best Interest: The Broker-Dealer Standard of Conduct AGENCY: Securities and Exchange Commission. ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (the ''Commission'') is adopting a new rule under the Securities Exchange Act of 1934 (''Exchange Act''), establishing a standard of conduct for broker-dealers and natural persons who are associated persons of a broker-dealer (unless otherwise indicated, together referred to as ''broker-dealer'') when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities (''Regulation Best Interest''). Regulation Best Interest enhances the broker-dealer standard of conduct beyond existing suitability obligations, and aligns the standard of conduct with retail customers' reasonable expectations by requiring broker-dealers, among other things, to: Act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and address conflicts of interest by establishing, maintaining, and enforcing policies and procedures reasonably designed to identify and fully and fairly disclose material facts about conflicts of interest, and in instances where we have determined that disclosure is insufficient to reasonably address the conflict, to mitigate or, in certain instances, eliminate the conflict. The standard of conduct established by Regulation Best

Interest cannot be satisfied through disclosure alone. The standard of conduct draws from key principles underlying fiduciary obligations, including those that apply to investment advisers under the Investment Advisers Act of 1940 (''Advisers Act''). Importantly, regardless of whether a retail investor chooses a broker-dealer or an investment adviser (or both), the retail investor will be entitled to a recommendation (from a broker-dealer) or advice (from an investment adviser) that is in the best interest of the retail investor and that does not place the interests of the firm or the financial professional ahead of the interests of the retail investor.

Recommendations that fall under the best interest standard of conduct.

Best Interest regulation applies to recommendations to natural persons who Use the recommendation primarily for personal, family, or household purposes.

Reg BI only applies to recommendations to "retail customers." Reg BI defines a "retail customer" as a natural person, or the legal representative of such person, who:

(a) receives a recommendation of any securities transaction or investment strategy involving securities from a BD or AP; and

(b) uses the recommendation primarily for personal, family or household purposes.

"Uses" means when, as a result of the recommendation:

- the retail customer opens a brokerage account with the BD, regardless of whether the BD receives compensation;
- the retail customer has an existing account with the BD and receives a recommendation from the BD, regardless of whether the BD receives or will receive compensation, directly or indirectly, as a result of the recommendation; or
- the BD receives or will receive compensation, directly or indirectly, as a result of that recommendation, even if that retail customer does not have an account at the firm.

The phrase "primarily for personal, family, or household purposes" covers any recommendation to a natural person for his or her account, other than recommendations to a natural person seeking these services for commercial or business purposes.

The standards are for all types of investment recommendations, from a standard savings in an annuity to an IRA. Different investment products have many fees and expenses, penalties for early withdrawals, penalties for late withdrawals (an IRA may have a required minimum distribution). These are a few of the items to be considered and explained.

Care Obligation

https://www.sec.gov/info/smallbus/secg/regulation-best-interest#Care_Obligation

Under the Care Obligation, you must exercise **reasonable diligence, care, and skill** when making a recommendation to a retail customer to:

- understand potential risks, rewards, and costs associated with recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers**;**
- have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the interest of the broker-dealer ahead of the interest of the retail customer; and
- have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

Whether you have complied with the Care Obligation will be evaluated as of the time of the recommendation (and not in hindsight).

What does the first component of the Care Obligation require?

You must exercise reasonable diligence, care, and skill to understand the potential risks, rewards, and costs associated with the recommendation.

What would constitute reasonable diligence, care, and skill will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy.

While every inquiry will be specific to the particular broker-dealer and the recommended security or investment strategy, you generally should consider ***important factors*** such as:

- the security's or investment strategy's:
  - investment objectives;
  - characteristics (including any special or unusual features);
  - liquidity;
  - volatility; and
  - likely performance in a variety of market and economic conditions;
- the expected return of the security or investment strategy; and
- any financial incentives to recommend the security or investment strategy.

Together, this inquiry should allow you to develop a sufficient understanding of the security or investment strategy and to be able to reasonably believe that it could be in the best interest of at least some retail customers.

What does the second component of the Care Obligation require?

You must consider the risks, rewards, and costs in light of the retail customer's investment profile and have a reasonable basis to believe that the recommendation is in that particular customer's best interest and does not place the broker-dealer's interest ahead of the customer's interest.

The ***retail customer's investment profile*** is defined to include, but is not limited to the retail customer's:

- age;
- other investments;
- financial situation and needs;
- tax status;
- investment objectives;
- investment experience;
- investment time horizon;
- liquidity needs;
- risk tolerance; and
- any other information the retail customer may disclose to the broker in connection with a recommendation

What does the third component of the Care Obligation require?

When recommending a series of transactions, you must have a reasonable basis to believe that the transactions taken together are not excessive, even if each is in your customer's best interest when viewed in isolation. The requirement applies irrespective of whether you exercise actual or *de facto* control over a customer's account.

What would constitute a "series" of recommended transactions would depend on the facts and circumstances, and would need to be evaluated with respect to a particular retail customer.

Disclosure Obligation

In financial planning, disclosure is critical to both parties. The insurance company providing the annuity does not want to take advantage of clients and must relate both the risks and fees up front as well as the benefits so the client knows what they are buying. The client needs to understand annuities are fantastic products, but not necessarily for everyone. There are fees involved in the product, early withdrawal penalties, as well as the fact that if a person has chosen a life option they cannot surrender the contract.

Insurance Producer Disclosure for Annuities form

The Disclosure Obligation requires a form is signed by the client - prior to the sale - with basic information about the producer, insurer, types of products they can sell, and if the client asks, the commissions and non cash compensation earned on this sale. See appendix A

Conflict of Interest Obligation

https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf

Conflict of interest obligation. A producer shall identify and avoid or reasonably manage and disclose material conflicts of interest, including material conflicts of interest related to an ownership interest.

https://www.sec.gov/info/smallbus/secg/regulation-best-interest#Care_Obligation

The Conflict of Interest Obligation (and the Compliance Obligation discussed below), applies solely to the broker- dealer entity, and not to the associated persons of a broker-dealer. For purposes of discussing the Conflict of Interest Obligation, the term “broker-dealer” or “you” refers only to the broker-dealer entity, and not to such individuals.

Under the Conflict of Interest Obligation, a broker-dealer must establish, maintain, and enforce written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations to retail customers.

Specifically, the ***written policies and procedures*** must be reasonably designed to:

Identify and at a minimum disclose, pursuant to the Disclosure Obligation, or eliminate all conflicts of interest associated with such recommendations;

Identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for the broker-dealer’s associated persons to place their interest or the interest of the broker-dealer ahead of the retail customer’s interest;

Identify and disclose any ***material limitations***, such as ***a limited product menu*** or ***offering only proprietary products***, placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the broker-dealer or the associated person to place the interest of the broker-dealer or the associated person ahead of the retail customer’s interest; and

Identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

How should you develop policies and procedures to mitigate certain incentives to associated persons?

Your policies and procedures must be reasonably designed to reduce the potential effect such conflicts may have on a recommendation given to a retail customer.

You have flexibility to develop and tailor reasonably designed policies and procedures that include conflict mitigation measures, based on your circumstances, such as your size, retail customer base (for example, the diversity of investment experience and financial needs), and

the complexity of the security or investment strategy involving securities that is being recommended, some of which may be weighed more heavily than others.

Policies and procedures may be reasonably designed at the outset, but may later cease to be reasonably designed based on subsequent events or information obtained, for example, through supervision (e.g., exception testing) of associated person recommendations. Your actual experience should be used to revise your measures as appropriate.

Cash and non-cash compensation

Non-Cash Compensation Rules

https://www.finra.org/rules-guidance/key-topics/gifts-gratuities-and-non-cash-compensation

FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company), 2341 (Investment Company Securities), 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) (together, the Non-Cash Compensation Rules) impose restrictions on non-cash arrangements that are in connection with the sale and distribution of securities covered by those rules. The Non-Cash Compensation Rules prohibit a member firm or associated person from directly or indirectly accepting or making payments of any non-cash compensation, subject to specified exceptions.

The exceptions permit:

gifts that do not exceed an annual amount per person fixed by the FINRA Board of Governors (currently $100) and are not preconditioned on achievement of a sales target;

an occasional meal, a ticket to a sporting event or the theater or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target;

payment or reimbursement by “offerors” (product issuers, advisers, underwriters and their affiliates) in connection with training or education meetings, subject to certain conditions, including meeting location restrictions and not preconditioning attendance on achievement of a sales target; and

internal firm non-cash compensation arrangements that are based on total production and equal weighting of product sales. (Rules 2310 and 5110 do not impose total production and equal weighting requirements on internal non-cash compensation arrangements.)

Effective June 30, 2020, SEC Regulation Best Interest (Reg BI) establishes a standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities. Reg BI requires broker-dealers to act in the best interest of the retail customer at the time the

recommendation is made, without placing the financial interest of the broker-dealer ahead of the interests of the retail customer.

Reg BI requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all conflicts associated with such recommendations. Among other things, broker-dealers must identify and eliminate any sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time. Accordingly, in addition to Non-Cash Compensation Rules' restrictions, any non-cash compensation arrangement must be consistent with the requirements of Reg BI.

Ownership interest

https://www.federalregister.gov/documents/2019/07/12/2019-12164/regulation-best-interest-the-broker-dealer-standard-of-conduct

> *Third,* under the Conflict of Interest Obligation,[19] a broker-dealer must establish, maintain, and enforce reasonably designed written policies and procedures addressing conflicts of interest associated with its recommendations to retail customers. These policies and procedures must be reasonably designed to identify all such conflicts and at a minimum disclose or eliminate them. Importantly, the policies and procedures must be reasonably designed to mitigate conflicts of interests that create an incentive for an associated person of the broker-dealer to place its interests or the interest of the firm ahead of the retail customer's interest. Moreover, when a broker-dealer places material limitations on recommendations that may be made to a retail customer (*e.g.,* offering only proprietary or other limited range of products), the policies and procedures must be reasonably designed to disclose the limitations and associated conflicts and to prevent the limitations from causing the associated person or broker-dealer from placing the associated person's or broker-dealer's interests ahead of the customer's interest. Finally, the policies and procedures must be reasonably designed to identify and eliminate sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or specific types of securities within a limited period of time.

Documentation Obligation

https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf

(4) Documentation obligation. A producer shall at the time of recommendation or sale:

(a) Make a written record of any recommendation and the basis for the recommendation subject to this regulation;

(b) Obtain a consumer signed statement on a form substantially similar to Appendix B documenting:

(i) A customer's refusal to provide the consumer profile information, if any; and

(ii) A customer's understanding of the ramifications of not providing his or her consumer profile information or providing insufficient consumer profile information; and

(c) Obtain a consumer signed statement on a form substantially similar to Appendix C acknowledging the annuity transaction is not recommended if a customer decides to enter into an annuity transaction that is not based on the producer's recommendation.

(5) Application of the best interest obligation. Any requirement applicable to a producer under this subsection shall apply to every producer who has exercised material control or influence in the making of a recommendation and has received direct compensation as a result of the recommendation or sale, regardless of whether the producer has had any direct contact with the consumer. Activities such as providing or delivering marketing or educational materials, product wholesaling or other back office product support, and general supervision of a producer do not, in and of themselves, constitute material control or influence.

https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf

Recordkeeping

A. Insurers, general agents, independent agencies and producers shall maintain or be able to make available to the commissioner records of the information collected from the consumer, disclosures made to the consumer, including summaries of oral disclosures, and other information used in making the recommendations that were the basis for insurance transactions for [insert number] years after the insurance transaction is completed by the insurer. An insurer is permitted, but shall not be required, to maintain documentation on behalf of a producer. Drafting Note: States should review their current record retention laws and specify a time period that is consistent with those laws. For some states this time period may be five (5) years.

B. Records required to be maintained by this regulation may be maintained in paper, photographic, microprocess, magnetic, mechanical or electronic media or by any process that accurately reproduces the actual document. Drafting Note: This section may be unnecessary in states that have a comprehensive recordkeeping law or regulation.

https://www.sec.gov/info/smallbus/secg/regulation-best-interest#Record_making_and_Recordkeeping
Record-making and Recordkeeping

You must meet new record-making and recordkeeping requirements with respect to certain information collected from or provided to retail customers in connection with Regulation Best Interest. This builds upon existing record-making and recordkeeping obligations.

- For each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided, you must keep a record of all information collected from and provided to the retail customer pursuant to Regulation Best Interest, as well as the identity of each natural person who is an associated person, if any, responsible for the account.
- You must retain all records of the information collected from or provided to each retail customer for at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

Supervision System

https://www.sec.gov/tm/faq-regulation-best-interest

Compliance Obligation

Q: Are firms required to build new systems of controls and compliance in order to satisfy the Compliance Obligation?

A: The Compliance Obligation requires that firms establish, maintain and enforce, written policies and procedures that are reasonably designed to achieve compliance with Regulation Best Interest. The Commission has stated that these policies and procedures should be reasonably designed to address and be proportionate to the scope, size and risks associated with the operations of the firm and types of business in which the firm engages. In adopting the requirement, the Commission did not mandate specific requirements but provided flexibility to allow broker-dealers to establish compliance policies and procedures that accommodate a broad range of business models.

Broker-dealers are currently subject to supervisory obligations under federal securities laws and regulations, as well as applicable self-regulatory organization rules, and broker-dealers could choose to satisfy the Compliance Obligation by adjusting/building upon their current systems of supervision and compliance, as opposed to creating entirely new systems. (Posted February 11, 2020)

https://content.naic.org/sites/default/files/inline-files/MDL-275.pdf

C. Supervision system.

(1) Except as permitted under Subsection B (transactions not based on a recommendation), an insurer may not issue an annuity recommended to a consumer unless there is a reasonable basis to believe the annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives based on the consumer's consumer profile information.

(2) An insurer shall establish and maintain a supervision system that is reasonably designed to achieve the insurer's and its producers' compliance with this regulation, including, but not limited to, the following:

(a) The insurer shall establish and maintain reasonable procedures to inform its producers of the requirements of this regulation and shall incorporate the requirements of this regulation into relevant producer training manuals;

(b) The insurer shall establish and maintain standards for producer product training and shall establish and maintain reasonable procedures to require its producers to comply with the requirements of Section 7 of this regulation;

(c) The insurer shall provide product-specific training and training materials which explain all material features of its annuity products to its producers; Suitability in Annuity Transactions Model Regulation 275-8 © 2020 National Association of Insurance Commissioners

(d) The insurer shall establish and maintain procedures for the review of each recommendation prior to issuance of an annuity that are designed to ensure there is a reasonable basis to determine that the recommended annuity would effectively address the particular consumer's financial situation, insurance needs and financial objectives. Such review procedures may apply a screening system for the purpose of identifying selected transactions for additional review and may be accomplished electronically or through other means including, but not limited to, physical review. Such an electronic or other system may be designed to require additional review only of those transactions identified for additional review by the selection criteria;

(e) The insurer shall establish and maintain reasonable procedures to detect recommendations that are not in compliance with Subsections A, B, D and E. This may include, but is not limited to, confirmation of the consumer's consumer profile information, systematic customer surveys, producer and consumer interviews, confirmation letters, producer statements or attestations and programs of internal monitoring. Nothing in this subparagraph prevents an insurer from complying with this subparagraph by applying sampling procedures, or by confirming the consumer profile information or other required information under this section after issuance or delivery of the annuity;

(f) The insurer shall establish and maintain reasonable procedures to assess, prior to or upon issuance or delivery of an annuity, whether a producer has provided to the consumer the information required to be provided under this section;

(g) The insurer shall establish and maintain reasonable procedures to identify and address suspicious consumer refusals to provide consumer profile information;

(h) The insurer shall establish and maintain reasonable procedures to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific annuities within a limited period of time. The requirements of this subparagraph are not intended to prohibit the receipt of health insurance, office rent, office support, retirement benefits or other employee benefits by employees as long as those benefits are not based upon the volume of sales of a specific annuity within a limited period of time; and Drafting Note: The intent of Subparagraph (h) is to prohibit sales contests, sales quotas, bonuses and non-cash compensation based on the sale of a particular product within a limited period of time, but not to prohibit general incentives regarding the sales of a company's products with no emphasis on any particular product.

(i) The insurer shall annually provide a written report to senior management, including to the senior manager responsible for audit functions, which details a review, with appropriate testing, reasonably designed to determine the effectiveness of the supervision system, the exceptions found, and corrective action taken or recommended, if any

(3) (a) Nothing in this subsection restricts an insurer from contracting for performance of a function (including maintenance of procedures) required under this subsection. An insurer is responsible for taking appropriate corrective action and may be subject to sanctions and penalties pursuant to Section 8 of this regulation regardless of whether the insurer contracts for performance of a function and regardless of the insurer's compliance with Subparagraph (b) of this paragraph.

(b) An insurer's supervision system under this subsection shall include supervision of contractual performance under this subsection. This includes, but is not limited to, the following:

(i) Monitoring and, as appropriate, conducting audits to assure that the contracted function is properly performed; and NAIC Model Laws, Regulations, Guidelines and Other Resources—Spring 2020 © 2020 National Association of Insurance Commissioners 275-9

(ii) Annually obtaining a certification from a senior manager who has responsibility for the contracted function that the manager has a reasonable basis to represent, and does represent, that the function is properly performed.

(4) An insurer is not required to include in its system of supervision:

(a) A producer's recommendations to consumers of products other than the annuities offered by the insurer; or

(b) Consideration of or comparison to options available to the producer or compensation relating to those options other than annuities or other products offered by the insurer.

Section IV – What is an Annuity?

An annuity is a contract between a person and an insurance company that is designed to meet retirement and other long-range goals, under which is made a lump-sum payment or a series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date.

Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a specified minimum amount, such as your total purchase payments. While tax is deferred on earnings growth, when withdrawals are taken from the annuity, gains are taxed at ordinary income rates, and not capital gains rates. If you withdraw your money early from an annuity, you may pay substantial surrender charges to the insurance company, as well as tax penalties.

There are generally three types of annuities — *fixed, indexed, and variable*. In a fixed annuity, the insurance company agrees to pay you no less than a specified rate of interest during the time that your account is growing. The insurance company also agrees that the periodic payments will be a specified amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

In an indexed annuity, the insurance company credits you with a return that is based on changes in an index, such as the S&P 500 Composite Stock Price Index. Indexed annuity contracts also provide that the contract value will be no less than a specified minimum, regardless of index performance.

In a variable annuity, you can choose to invest your purchase payments from among a range of different investment options, typically mutual funds. The rate of return on your purchase payments, and the amount of the periodic payments you eventually receive, will vary depending on the performance of the investment options you have selected.

Variable annuities are securities regulated by the SEC. An indexed annuity may or may not be a security; however, most indexed annuities are not registered with the SEC. Fixed annuities are not securities and are not regulated by the SEC.

A variable annuity is a contract between you and an insurance company, under which you make a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date. You can choose to invest your purchase payments in a range of investment options, which are typically mutual funds. The value of your account in a variable annuity will vary, depending on the performance of the investment options you have chosen.

Variable annuities also offer many of the features of other types of annuities. These include:

- Tax-deferred growth of earnings
- A death benefit that will pay to your beneficiary the greater of your account value or a guaranteed minimum amount, such as your total purchase payments
- The option of receiving a stream of periodic payments for either a definite period, such as 20 years or an indefinite period, such as your lifetime or the life of your spouse

Variable annuities have become a part of the retirement and investment plans of many Americans. Before a person buys a variable annuity, they should know some of the basics and be prepared to ask their insurance agent, broker, financial planner, or other financial professional lots of questions about whether a variable annuity is right for them.

Before buying any variable annuity, however, the person should find out about the particular annuity they are considering. A person should ***request a prospectus from the insurance company or from a financial professional, and read it carefully***.

The prospectus contains important information about the annuity contract, including fees and charges, investment options, death benefits, and annuity payout options. A person should compare the benefits and costs of the annuity to other variable annuities and to other types of investments, such as mutual funds.

What Is a Variable Annuity?

A variable annuity is a contract between a person and an insurance company, under which the insurer agrees to make periodic payments, beginning either immediately or at some future date. A variable annuity contract is purchased by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of your investment as a variable annuity owner will vary depending on the performance of the investment options you choose. 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 variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

First, variable annuities let you receive **periodic payments** for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.

Second, variable annuities have a **death benefit.** If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount – typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.

Third, variable annuities are **tax-deferred**. That means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed 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 you hold it as a long-term investment to meet retirement and other long-range goals.

Caution!

Other investment vehicles, such as IRAs and employer-sponsored 401(k) plans, also may provide you with tax-deferred growth and other tax advantages. For most investors, it will be advantageous to make the maximum allowable contributions to IRAs and 401(k) plans before investing in a variable annuity.

In addition, if you are investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), you will get **no additional tax advantage** from the variable annuity. Under these circumstances, consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection. The tax rules that apply to variable annuities can be complicated – before investing, you may want to consult a tax adviser about the tax consequences to you of investing in a variable annuity.

Remember: Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if you withdraw your money early. Variable annuities also involve investment risks, just as do mutual funds.

How Variable Annuities Work

A variable annuity has two phases: an **accumulation phase** and a **payout phase**.

During the **accumulation phase**, you make purchase payments, which you can allocate to a number of investment options. For example, you could designate 40% of your purchase payments to a bond fund, 40% to a U.S. stock fund, and 20% to an international stock fund. The money you have allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, variable annuities often allow you to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (*e.g.*, 3% per year).

Your most important source of information about variable annuities and investment options is the prospectus. Request the prospectuses for the mutual fund investment options. Read them carefully before you allocate your purchase payments among the investment options offered. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio. The SEC's online publication, *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, provides information about these factors. Another SEC online publication, *Invest Wisely: An Introduction to Mutual Funds*, provides general information about the types of mutual funds and the expenses they charge.

During the accumulation phase, you can typically transfer your money from one investment option to another without paying tax on your investment income and gains, although you may be charged by the insurance company for transfers. However, if you withdraw money from your account during the early years of the accumulation phase, you may have to pay "surrender charges". In addition, you may have to pay a 10% federal tax penalty if you withdraw money before the age of 59½.

At the beginning of the **payout phase**, you may receive your purchase payments plus investment income and gains (if any) as a lump-sum payment, or you may choose to receive them as a stream of payments at regular intervals (generally monthly).

If you choose to receive a stream of payments, you may have a number of choices of how long the payments will last. Under most annuity contracts, you can choose to have your annuity payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of you and your spouse or other beneficiary). During the payout phase, your annuity contract may permit you to choose between receiving payments that are fixed in an amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that you select for receiving payments. Be aware that some annuities do not allow you to withdraw money from your account once you have started receiving regular annuity payments.

In addition, some annuity contracts are structured as **immediate annuities**, which means that there is no accumulation phase and you will start receiving annuity payments right after you purchase the annuity.

The Death Benefit and Other Features

A common feature of variable annuities is the death benefit. If you die, a person you select as a beneficiary (such as your spouse or child) will receive the greater of: (i) all the money in your account, or (ii) some guaranteed minimum (such as all purchase payments minus prior withdrawals).

Example: You own a variable annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. You have made purchase payments totaling $50,000. In addition, you have withdrawn $5,000 from your account. Because of these withdrawals and investment losses, your account value is currently $40,000. If you die, your designated beneficiary will receive $45,000 (the $50,000 in purchase payments you put in minus $5,000 in withdrawals). This is a guaranteed death benefit.

Some variable annuities allow you to choose a “stepped-up” death benefit. Under this feature, your guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be your account value as of a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to “lock in” your investment performance and prevent a later decline in the value of your account from eroding the amount that you expect to leave to your heirs. This feature carries a charge, however, which will reduce your account value.

Variable annuities sometimes offer other optional features, which also have extra charges. One common feature, the guaranteed minimum income benefit, guarantees a particular minimum level of annuity payments, even if you do not have enough money in your account (perhaps because of investment losses) to support that level of payments. Other features may include long-term care insurance, which pays for home health care or nursing home care.

You may want to consider the financial strength of the insurance company that sponsors any variable annuity you are considering buying. This can affect the company’s ability to pay any benefits that are greater than the value of your account in mutual fund investment options, such as a death benefit, guaranteed minimum income benefit, long-term care benefit, or amounts you have allocated to a fixed account investment option.

Caution!

You will pay for each benefit provided by your variable annuity. Be sure you understand the charges. Carefully consider whether you need the benefit. If you do, consider whether you can buy the benefit more cheaply as part of the variable annuity or separately (*e.g.*, through a long-term care insurance policy).

Variable Annuity Charges

You will pay several charges when you invest in a variable annuity. Be sure you understand all the charges before you invest. **These charges will reduce the value of your account and the return on your investment.**

- **Mortality and expense risk charge** – This charge is equal to a certain percentage of your account value, typically in the range of 1.25% per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to your financial professional for selling the variable annuity to you.

  Example: Your variable annuity has a mortality and expense risk charge at an annual rate of 1.25% of account value. Your average account value during the year is $20,000, so you will pay $250 in mortality and expense risk charges that year.

- **Administrative fees** – The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of your account value (typically in the range of 0.15% per year).

  Example: Your variable annuity charges administrative fees at an annual rate of 0.15% of account value. Your average account value during the year is $50,000. You will pay $75 in administrative fees.

- **Underlying Fund Expenses** are imposed by the mutual funds that are the underlying investment options for your variable annuity.

- **Fees and Charges for Other Features** – Special features offered by some variable annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges.

Other charges, such as initial sales loads, or fees for transferring part of your account from one investment option to another, may also apply. You should ask your financial professional to explain to you all charges that may apply. You can also find a description of the charges in the prospectus for any variable annuity that you are considering.

Section V – Parties to an Annuity Contract

An annuity is a contract between an annuity owner and an insurance company. However, while most other types of contracts involve only two parties, an annuity involves more because the contract's rights and benefits are measured by the life of a third party, who is called the annuitant. In addition, because disbursement of annuity values can occur after the death of the contract owner or annuitant, another party is usually named in the contract and is called a beneficiary.

Deciding who to name as the owner, annuitant, and beneficiary of an annuity is commonly referred to as "structuring the contract." Usually, the structure of an annuity contract is kept fairly simple by naming the same individual as both owner and annuitant. If that individual dies, any remaining annuity value is paid to the beneficiary. This simple structure generally assures that the benefits of the contract flow to the parties that the purchaser intended.

Contract Owner' Rights

While the annuitant is living, the contract owner generally has the power to do the following:

- Name the annuitant
- State and change the annuity starting date
- Choose (and change, prior to the annuity starting date) the payout option
- Name and change the beneficiary
- Request and receive the proceeds of a partial or full surrender
- Initiate and change the status of a systematic withdrawal
- Assign or otherwise transfer ownership of the contract to other parties
- Amend the contract with the issuing company's consent

Natural Person --- ***The annuitant must be an individual (or in the case of joint annuitants, two individuals). If a trust, corporation, or other non-natural person were the annuitant, there would be no natural life by which to measure the benefits of the contract***.

Take Care With More Complex Structures

However, there are situations that call for the annuitant to be someone other than the owner of the annuity. In *such* cases, you must take care to ensure that various contingencies do not have unintended consequences.

- For example, let's say that John is the owner of a deferred annuity that is still in the deferral period. His wife Mary is the annuitant, and his son Cory is the beneficiary. If Mary dies while John is still alive, should the value of the annuity be paid immediately to Cory or kept under John's control? You must know the answer to that question in order to structure the contract properly.

Variations in Contract Language

What can complicate the matter is that owner, annuitant, and beneficiary provisions vary somewhat from contract to contract. For example, under some contracts, John would automatically become the annuitant and the annuity would simply continue if Mary died while he was still alive. Under other contracts, the value of the annuity would immediately be paid to Cory and the contract would cease upon Mary's death regardless of whether John was still living. There are other possibilities. Only by reading the contract in question can you determine what rights and benefits pertain to the various parties under a particular annuity.

A complex structure may be appropriate in certain cases, but make sure you consider how all the contingencies will be handled under the contract in question. In most situations, the simple contract structure, with its more straightforward control and benefit flow, will be the most desirable way to structure the contract.

Let's say that under John's deferred annuity, the maximum age to which the annuity starting date may be deferred is 75. However, John is age 80, and he wants to obtain income via a systematic withdrawal rather than an income option. In order to maintain the annuity in its deferral period, John names his son Cory, age 40, as the annuitant, though he retains ownership of the contract so that he can effect a systematic withdrawal from it. If John's rights would cease in the event of Cory's death, however, John will lose control of his funds in the event that Cory predeceases him.

To avoid that risk, John should also name himself beneficiary under the contract. Under such an arrangement, John would incur income taxes on the earnings if the annuity value were paid to him in the event of Cory's death, but at least those funds wouldn't be paid to a different party. Cory could be named contingent beneficiary in the event of John's death.

Under other contracts, the owner's rights do not automatically cease when the annuitant dies. If the owner is not the annuitant and the annuitant dies first, some contracts provide that the owner automatically becomes the annuitant. Other contracts provide for a period of time in which the owner can name a new annuitant, after which, if a new annuitant is not named, the owner becomes the new annuitant. Still other contracts provide for a contingent owner to assume ownership of the contract in the event the original owner dies before the annuitant.

Purchaser, Others As Owner

In most cases the purchaser of the contract names himself or herself as owner. However, sometimes the purchaser names another party, such as a trust, as owner. For example, trust ownership may be used when the purchaser wishes to make a gift to a minor. Certain forms of trust ownership may shift income and estate taxation of the benefits of the contract away from the purchaser. However, the purchaser may be liable for gift taxes on the value of the annuity and/or the premiums paid on it.

In general, it is the owner of the annuity who is taxed on any amounts disbursed from the annuity during the annuitant's lifetime. This is true *even if* someone else is receiving annuity benefit payments. Naming another person as annuitant does not shift tax liability away from the owner. Only a gift or other transfer of ownership can do that.

Remember that, with certain exceptions, if the owner of the annuity is not a natural person, the annuity does not provide income tax-deferral on accumulations. The major exceptions to the non-natural person rule are a trust acting as agent for a natural person, a qualified plan, or the estate of a deceased owner.

Federal tax law requires that certain distributions be made from an annuity in the event that any owner of the contract dies. If the owner of the contract is not a natural person, then the annuitant will be considered the owner for the purposes of the rule, and a change of annuitant is treated the same as the death of an owner for tax purposes.

Required distributions are as follows:

- If an owner dies after the annuity starting date, any remaining payments that are due under the annuity must continue to be made at least as quickly as payments were being made prior to the death of the owner.

- If the owner dies before the annuity starting date, the entire value of the annuity must either be distributed within five years of the date of the owner's death, or the value of the annuity must be annuitized within one year of the date of the owner's death.

Spousal Exception

There is one exception to the rule requiring distributions in the event of an owner's death. If the beneficiary of the annuity is the surviving spouse of the deceased owner, then the surviving spouse is permitted to become the owner. Distributions will not be required until the surviving spouse's subsequent death.

Effect of Rules on Joint Ownership are designed to prevent the use of joint ownership to obtain tax deferral on annuity earnings over more than one lifetime, except in the case of married couples.

- For example, let's say that Ed purchases a deferred annuity with $100,000 at age 65 and names his daughter Tamara, age 40, as joint owner. Ed doesn't need income, so he lets earnings accumulate in the annuity on a tax-deferred basis until his death at age 75. At that point, if the annuity had credited 8% each year, the annuity would contain $115,892 of as-yet untaxed earnings, when Tamara succeeded to its ownership. In the absence of the rule just described, Tamara could continue to accumulate and defer taxation of those annuity earnings for the remainder of her life, or even longer if she named another joint owner.

The required distribution rules apply to contracts issued after January 18, 1985. For contracts issued today, there are only a few situations that might call for joint ownership of an annuity. In the case of married couples, the effect of joint ownership for purposes of successor ownership is best obtained by having one spouse be the owner and the other spouse be the beneficiary. In the event of the owner's death, the spouse can succeed to ownership by application of the spousal exception to the required distribution rule.

If joint ownership by a married couple is desirable for other reasons, be sure that each spouse names the other as primary beneficiary—for the spousal exception to the required distribution rules to apply, the surviving spouse must be the designated beneficiary of the contract.

Other – Joint Survivorship Considerations

Consumers may say they desire joint ownership because they are under the misconception that joint ownership of an annuity is like a joint bank account. It is not.

With a joint bank account, either of the persons named on the account can make a withdrawal from the account independent of the other. However, with joint ownership of an annuity, the signatures of both owners are required to exercise the rights of ownership.

Further, if a withdrawal is taken, both joint owners receive a 1099 form, each for one-half the amount of the withdrawal. This means that each joint owner assumes the tax liability for one-half of every withdrawal, even if the entire withdrawal was spent by only one of the owners. Any joint owner under age 59 $^{1/2}$ would also be liable for the 10% penalty tax on any taxable amount of his or her portion of the withdrawal, unless an exception applied.

The desirability of joint ownership in light of these complexities should be carefully reviewed before naming more than one owner to an annuity.

Joint ownership of IRAs is prohibited by the law governing IRAs.

Annuitant

Many annuity contracts define the annuitant as the individual who is designated to receive income benefits under the contract. However, under some contracts, as well as in the tax law, the annuitant is defined as the individual upon whose life income benefits will be based—the benefits themselves may actually be paid to a different party.

Even under a contract that allows for a different payee, it is usually the case that the annuitant will be the recipient of income benefits under the annuity. And even if benefits are paid to a different party, it is the annuitant who serves as the "measuring life" in reference to those benefits.

Must Be a Natural Person

The annuitant must be an individual (or in the case of joint annuitants, two individuals). If a trust, corporation, or other non-natural person were the annuitant, there would be no natural life by which to measure the benefits of the contract.

Role of an Annuitant

The role of the annuitant as the measuring life under an annuity contract is similar to the role of the insured under a life insurance policy. Just as it is the insured's age which determines the premium rates for a life insurance policy, it is the annuitant's age which determines the benefits payable under an annuity. And just as it is the insured's death which triggers the payment of benefits under a life insurance policy, it is the attainment of a given *age* on the part of the annuitant that triggers the annuity starting date under an annuity. And just as the insured is usually also the owner of a life insurance policy, the annuitant is usually also the owner of an annuity, though there are exceptions, as we've mentioned previously.

Some contracts allow the owner to name joint annuitants. However, having joint annuitants to a deferred annuity may unnecessarily increase the risk that unwanted changes will be made to the contract prior to the annuity starting date. This is because the risk of death for either of two people is higher than the risk of death for one person. Under some contracts, the value of the annuity would be paid immediately to the beneficiary. Under others, the owner could change the annuitant designation. But if the owner is not an individual, this change would be treated the same for tax purposes as the death of an owner, triggering required distributions from the contract.

The increased risk of naming joint annuitants may be unnecessary because even if only one annuitant is named under a deferred annuity contract, a joint-and-survivor income option can be chosen at the annuity starting date. If a guaranteed lifetime income stream over the lives of two individuals is desired, this objective can be achieved without naming joint annuitants during the deferral period.

As mentioned earlier, it is generally the owner rather than the annuitant who is taxed on annuity payments. If the owner and the annuitant are the same person, of course, it is the owner/annuitant who is taxed.

However, even if the owner and annuitant are different persons, it is still with reference to the annuitant's life that the exclusion ratio for the payment is calculated.

Also, you should be aware that some contracts provide that the annuitant will become the owner of the contract after the annuity starting date. In that case, the annuitant, as owner, would become liable for the tax on the income-taxable portion of those payments.

The death of the annuitant, as the measuring life under the contract, causes major changes or in some cases even the cessation of the contract. We've already mentioned the possible effects of the annuitant's death prior to the annuity starting date.

If the annuitant dies after the annuity starting date, the income option under which annuity payments are being made controls what happens next.

- **Under a life only or pure income option, payments cease**.
- Under a life with period certain, period certain or refund payment option, the balance of any remaining guaranteed payments will be made to the **beneficiary**.
- *Under a joint-and-survivor payment option, payments will continue to the surviving annuitant for the remainder of his or her life*.

Miscellaneous Topics Relating to Annuities

There are close parallels between the roles of the owner and insured under a life insurance contract and the owner and annuitant under an annuity. There are also some parallels between the role of the beneficiary under these two contracts, but the purpose of the beneficiary is somewhat different under each.

Under a life insurance contract, the beneficiary is the person to whom the benefits of the contract are primarily intended to flow. But the benefits of an annuity are designed to flow primarily to the owner and annuitant—the beneficiary is only a sort of remainder man designated to receive benefits after the owner or annuitant's death.

Death is The Triggering Event

One similarity between life insurance and annuity contracts is that death is the event which triggers the payment of benefits to the beneficiary. However, with a life insurance contract, only one individual's death is relevant: the insured's. With an annuity, payment of the death benefit is triggered by operation of law upon the death of the owner and may also be triggered by the death of the annuitant, depending on how the pertinent provisions in the contract are worded.

If the owner and the annuitant are the same person, this potential complexity doesn't come into play.

Change of Beneficiary

Most annuities reserve the contract owner's right to change the beneficiary at any time during the annuitant's life. However, some contracts give the owner the option of naming a permanent, or irrevocable, beneficiary. If an irrevocable beneficiary is named, the beneficiary designation can later be changed only with the beneficiary's consent.

Death of Annuitant

Spouse or Children As Beneficiaries

In most cases, the beneficiary is the owner's spouse so that the spousal exception to the required distribution rules can be used to continue the contract in the event of the owner's death. Sometimes it is appropriate for the owner to name his or her child or children as beneficiaries. If a beneficiary is a minor child, the owner should have a will and name a guardian to receive the benefits on the child's behalf. Otherwise, the child's lack of legal competence will likely cause the insurer to delay paying the benefits until a guardian is appointed by a court.

Non-Natural Person as Beneficiary

In a few cases, it may be appropriate to name a trust or estate beneficiary under an annuity—a beneficiary need not be a natural person. If the proceeds are paid to a non natural person as a required distribution upon the owner's death prior to the annuity starting date, proceeds must be distributed within five years—the annuitization option will not be available, since the beneficiary is not a natural person.

Multiple Beneficiaries

More than one beneficiary can be named under an annuity. Most annuities provide that if more than one beneficiary is named, equal shares will be paid to each beneficiary unless the owner has specified otherwise.

Taxation of Beneficiary

While it is the owner who is taxed on an annuity during the annuitant's life, upon the annuitant's death it is the beneficiary who becomes liable for income tax on any gain paid out of the contract.

Also, in some cases, the beneficiary may become liable for the 10% penalty tax on premature distributions. This is because of the way the definition of "premature distribution" is written in the tax law for annuities purchased on a nonqualified basis. The 10% premature distribution penalty tax rule is similar for qualified plans, but written in slightly different terms that would allow any beneficiary to avoid the penalty tax in the event of the annuitant's death. But for annuities purchased on a nonqualified basis:

- The definition of a premature distribution is written with reference to the *taxpayer's* age. Upon the death of the annuitant, the beneficiary becomes the taxpayer rather than the owner.

- In addition, the distribution-at-death exception to the definition of "premature distribution" refers to the death of the *contract owner,* or to the annuitant *only if the owner is not a natural person.* If the owner and annuitant are different persons and the owner is a natural person, the distribution-at-death exception does not apply at the death of the annuitant.

Therefore, if an annuity is purchased on a nonqualified basis and the owner of the annuity is a natural person and is not the annuitant, the annuitant's beneficiary will be liable for the 10% penalty tax if he or she receives taxable death proceeds from the annuity when he or she is under age 59 $^{1/2}$.

The situation is not as unlikely as it may sound. Most annuities are purchased on a nonqualified basis, and if the husband of a married couple is the purchaser, he is likely to name himself owner. However, it is also common for a married couple to assume that the husband will die before the wife, since men have a shorter average life expectancy than women, so the owner may name his spouse as annuitant. And since it is assumed that the husband will have already died by the time the wife dies, the couple's child or children may be named as beneficiary.

However, as we've already seen, depending on the provisions in the contract, if the wife dies first, the husband's ownership rights may cease and the value of the annuity may be paid to the children. And if the children are under age 59 $^{1/2}$, they'll be liable for the 10% penalty tax as well as regular income tax on any gain paid out of the contract.

Better results can be obtained by having either the husband or wife be both owner and annuitant, and naming the other spouse beneficiary. Then regardless of who dies first, the spousal exception is available to continue the contract without income tax consequences. The children can be named as contingent beneficiaries in the event of a common disaster involving both the husband and wife.

The death of the beneficiary does not affect the contract itself. However, if the beneficiary dies before the owner or annuitant and a new beneficiary is not named, benefits may end up being paid to the owner's or annuitant's estate. If some other disposition is desired, the owner can name a contingent beneficiary to receive benefits in the event that the primary beneficiary is not living at the time benefits become payable.

Premiums

Companies generally set minimum and maximum limits on the premium amounts they will accept. Minimum limits are set in order to control the administrative costs the company incurs to credit each premium to the contract. Maximum limits are set in order to manage the company's liability for benefit payments under the contract. Minimum and maximum limits vary among companies and types of contracts.

Some flexible premium deferred annuities have minimum premiums of $10, $25 or $50. Others have minimums of $100, $200, or even $1,000. Sometimes the company will also limit the frequency with which premium payments may be made—for example, no more often than monthly. A separate set of minimums may apply if premiums are being paid via an automatic payment plan (such as automatic monthly transfers from the owner's checking account) or if the annuity is purchased under a qualified plan.

In addition, many companies have a minimum initial premium on flexible premium products that is higher than the minimum periodic premium. For example, a company may require a premium payment of at least $1,000 or even $10,000 to purchase the contract initially, though it will accept premiums of a lesser minimum amount from that point on. Like minimum periodic premiums, minimum initial premiums may be set at lower limits if the premiums are being paid via an automatic payment or investment plan or if the annuity is funding a qualified plan.

For single premium products, minimum premiums are typically $5,000 or $10,000. Many single premium contracts do not allow any premium payments other than the initial premium. However, some single premium contracts are designed to accept up to a certain number of additional premium payments within a limited period of time: for example, the purchaser may be permitted to pay five more premiums within the 12-month period following the payment of the initial premium.

Maximum Limit

Companies may place a maximum limit on the amount of premium they will accept during any one year and/or on the total amount of premium they will accept under any one contract. Typical maximums on total premiums range from $100,000 to $1,000,000. Some companies word their maximum premium provision so that premiums in excess of the limit can be paid with the company's consent. Some companies word their maximum premium provisions so that it simply reserves their right to refuse any premium that is not in accordance with their underwriting guidelines.

For annuities funding qualified plans, yearly maximums are effectively set by the qualified plan itself, and increase as time goes by. The annual contribution limits for IRAs and 403b arrangements change every year.

Guarantee of Principal is a reference to the fact that it is the insurance company, not the contract owner, that bears the investment risk under the contract. It carries the connotation that contract owners will always get back at least the amount they paid into the contract.

Effect of Surrender Charges

Companies incur acquisition costs when an annuity is sold. Generally, they expect to amortize those costs over a period of several years during which the owner keeps the contract in force. For contracts that are surrendered early, companies impose surrender charges to recoup their acquisition costs. These are also known as "contingent deferred sales charges" because their imposition is contingent on the owner's surrender of the contract and deferred until that time.

When contingent deferred sales charges are applied, the surrender value of a contract can sometimes be less than the total premium that was originally credited to the annuity fund. For example, let's say that John pays a $10,000 premium for a single premium annuity that is crediting 5% interest and has a 6% contingent deferred sales charge for the first five policy years. At the end of one year, John has $10,500 in his annuity. At that point, he surrenders it. Minus the surrender charge of $630 (6% x $10,500), John *receives* $9,870.

Preserving Principal in Any Event

Some contracts provide that surrender charges may not reduce the accumulated value beyond the amount of premium paid. Under such a contract, John would still receive $10,000 if he surrendered his contract at the end of its first year.

Not all contracts contain such a provision. The only way to tell whether or not a contract allows principal to be reduced by surrender charges is to read the provisions of the contract. Also, look at the schedule of guaranteed values. If in the early years the guaranteed surrender value is less than the premium paid, then principal is not protected against surrender charges.

Certificate (or "CD") Annuities

Annuities are often perceived to compete directly with bank certificates of deposit (CDs) as a vehicle for the consumer's savings dollar. Some annuities enhance this perception with features that closely resemble those of CDs. These are the so-called certificate annuities, sometimes referred to as certificates of annuity (C of As) or even certificate of deposit (CD) annuities.

Generally, certificate annuities offer purchasers a choice of time periods over which the current interest rate is guaranteed. The periods usually range from one to ten years, with the longer periods offering a higher rate, as bank CDs do.

Other types of annuities may also offer a choice of time periods with different current rates, but the defining characteristic of a certificate annuity is that surrender charge periods coincide with the rate guarantee periods. For example, if a purchaser chooses a three-year period, then surrender charges may apply only during that three-year period. At the end of three years, the owner has a period of time called a "window," which usually lasts 30 days, in which to decide whether to renew the annuity or surrender it. No surrender charges apply to either a renewal or a surrender.

If the owner renews the annuity, he chooses one of the time periods then offered by the company and a new surrender charge period begins. If the owner does nothing, the annuity may automatically renew at the rate then being offered for the same time period as the one that just expired.

Indexed Annuities in General

Deferred annuities for which the company declares the renewal rate are said to contain a "trust me" factor—that is, once the initial interest-crediting period is over, the purchaser has to trust the company to continue crediting a reasonable rate of interest at renewal. The company is under no obligation to credit anything higher than the guaranteed minimum, which is generally relatively low. Surrender charges may make it expensive for the owner to move his or her money out of the annuity if he or she is dissatisfied with the renewal rate.

Indexed annuities are designed to allay concerns about the "trust me" factor by using an index outside of the company's control as a reference point for setting current rates. There are many indexes that can be used for this purpose, but in general they all fall into one of two categories: bond (or "interest") indices, which change along with the interest rates being offered on new issues of a certain type of bond, and stock (or "equity") indices, which change along with the market value of a certain group of stocks. (Indexes)

Bond-Indexed Annuities

There are a number of bond indexes that a bond-indexed annuity might be linked to, but a commonly used index is the interest rate on 10-year Treasury notes. Usually, the current rate for an indexed annuity is not set at the full value of the index, but at a stated portion of the index. For example, a bond-indexed annuity might state that its current rate will be the interest rate on 10-year Treasury notes minus two percentage points. If one year later the interest rate on 10-year Treasury notes was 7.02%, the company would be obligated to credit 5.02% (7.02% — 2%) on the annuity.

It is important for the agent to understand exactly how the index will be used in determining the current rate of interest on the annuity, because there is wide variation among companies. For example, bond indexes change periodically. One company may use the average of the index for the month in which an owner's annuity renews, while another company may apply the rate determined with reference to the January average for all annuities renewing that year.

Some companies set a cap that limits how high the current rate can go, even if reference to the index would produce a higher rate. For example, if an indexed annuity crediting two percentage points less than the 10-year Treasury note set a cap of 8% on current rates, then even if the 10-year Treasury note rose to over 10%, the annuity would credit no more than 8%. Such caps protect the company against the financial strain that a rapid and substantial rise in the value of the index might otherwise cause.

Agents should also make sure that they know how long the indexing provision lasts in relation to the surrender charge period. Some contracts guarantee that the indexed rate will be used for the entire period that surrender charges apply, and others do not. If the term of the indexing provision expires before the end of the surrender charge period, then the annuity owner would be left in a "trust me" situation regarding the renewal rate for some period of time. If the indexing provision covers the entire surrender charge period, the owner would be free to move his or her money if the renewal rate after that time seemed unsatisfactory.

Equity-Indexed Annuities

Equities are generally thought of as offering the potential for high returns coupled with the risk of loss of principal. The special appeal of equity-indexed, or equity-linked, annuities is that they offer purchasers the opportunity to participate in the potential gains of the stock market *without* exposing principal to investment risk.

The typical equity-indexed annuity is **linked to the S&P (Standard & Poor's) 500.** If the index goes up, the annuity is credited with at least a portion—from 60% to **110%,** depending on the contract—of the increase. If the index goes down, however, neither the original principal nor any interest previously credited to the annuity is **reduced.**

Under some equity-indexed annuities, principal may be reduced by surrender charges during the contract's early years. But the annuity is guaranteed to earn some minimum rate of interest regardless of what happens to the index. It is common for equity-indexed annuities to guarantee the return of at least 90% of the purchaser's original premium, plus the greater of 3% annual interest or the amount of indexed-referenced interest credited to the contract since its inception.

Under some equity-indexed annuities, the interest rate credited to the annuity is reduced by an administrative charge. For example, if such an annuity had an administrative charge of one-half of one percentage point, and the increase in the index multiplied by the participation percentage equaled 8%, the rate credited to the annuity would be 7.5% (8% – .5%).

Equity-indexed annuities offer purchasers a choice of terms and participation percentages. Usually, the higher participation percentages are offered with longer policy terms.

As with bond-indexed annuities, some equity-indexed annuities place a cap on the current rate of interest that may be credited. Even if reference to the index would produce a higher rate, the rate credited to the annuity will not exceed the cap. Not all equity-indexed annuities have such caps.

Some variable annuities offer a "stepped-up" death benefit feature under which gains achieved in the separate account investment options may be preserved for the purpose of calculating the death benefit even if the accumulated value later drops. The stepped-up death benefit is generally calculated with reference to the highest accumulated value recorded at certain intervals—for example, every third or every fifth policy anniversary. The stepped-up death benefit may also include any premiums paid (minus any withdrawals taken) since that time.

However, some states require a full refund of premium for any contract returned during the free look period, even for variable annuities. Other states impose the full premium refund requirement only in cases of replacement. In either case, the full premium refund requirement puts the company at risk for investment results during the free look period.

There are two ways companies can respond in those cases. Some companies simply assume the investment risk for that period. Others avoid it by not allocating the premium according to the owner's instructions until the free look period expires. Instead, the premium is usually put into the money market investment option which offers the liquidity desirable for a short-term commitment and where the risk of a decline in unit value is very small. Generally, if the premium is not allocated according to the owner's instructions, regulations require that the owner be notified of that fact.

Inflation Riders

Some companies offer inflation riders, sometimes called COLA (cost-of-living allowance) or CPI (Consumer Price Index) riders, which provide an annuity payment that will increase over time. To pay for the increasing benefit, individuals generally receive a lower benefit to start with than they would have received without the inflation rider. However, as time goes on the benefit rises. The longer the individual lives, the greater the benefit of having the inflation rider.

Benefit increases may be scheduled to occur periodically at a given interest rate, or they may be tied to increases in a measure of inflation such as the CPI. Sometimes, a combination of the two approaches may be used. For example, an inflation rider may cause the benefit to increase by 10% every three years for the first 15 years of the payout period, and then provide for annual cost-of-Living adjustments every year after that. Individuals may be given a range of inflation rates to choose from when they purchase the rider, with the higher rates providing a relatively lower benefit at the start of the payout period. Riders that link increases to an index such as the CPI generally impose a cap on the amount that benefits can rise in any one year.

Inflation riders are generally purchased at the beginning of the payout period—when the premium is paid for immediate annuities, or when the premium is converted to annuity payments for deferred annuities. Inflation riders are a feature of fixed annuities. Variable annuity payments are provided with growth potential by linking the payment to the investment experience of the separate account. Historically, securities investments have kept pace with inflation over the long term.

General Provisions

Annuity contracts usually also include a number of general provisions that are similar to those included in many life insurance contracts.

Assignment Provision
The assignment provision acknowledges the owner's right to assign his or her rights under the contract to another person any time during the deferral period of a deferred annuity. Once annuity payments begin, the rights of the parties to the contract are established by the payout option chosen. If the owner dies before that time, the death benefit provisions of the contract control the disposition of the annuity's value. And if the contract is surrendered, of course, the contract ceases to exist. The assignment provision also usually disclaims the company's responsibility for the validity of any assignment, or for any payments made or actions taken prior to the time the company receives a written copy of the assignment at its home office.

The **Entire Contract Provision** states that the agreement between the company and the annuity owner is fully spelled out in the contract itself and in the application, if attached to the contract. This helps protect both the company and the owner from having misunderstandings arise after the contract is put into effect. Company rules and practices or oral statements made during the sales process are to have no affect on the terms of the annuity agreement unless they have been written into the contract or the application.

The **Incontestability Provision** is unique to life and health insurance contracts. It is a general principle of contract law that a contract can only be formed with the consent of the parties. If consent is obtained through fraud, no contract exists. However, the incontestability provision limits or waives the company's right to void the contract because of fraud.

Incontestability provisions are included in life insurance contracts to assure purchasers that the company will not raise a legal contest to the statements contained in the application in order to avoid paying benefits after the purchaser has died and is no longer in a position to defend his or her actions.

The incontestability provision in many annuities provides that the contract is incontestable from its inception. Some annuities and most life insurance policies provide that the contract may be contested only within a limited time period after it is issued, usually two years. Once that period expires, the company cannot contest the payment of benefits, even if it is discovered that the purchaser acted fraudulently in completing the application.

Misstatement of Age or Gender

Age is a key factor in determining the amount of life-contingent annuity benefits payable to an individual. Under many annuities, sex is also an important factor. The misstatement of age or sex provision describes the procedure for correcting the amount of payments if an error is discovered to have been made in stating the annuitant's age or sex in the application.

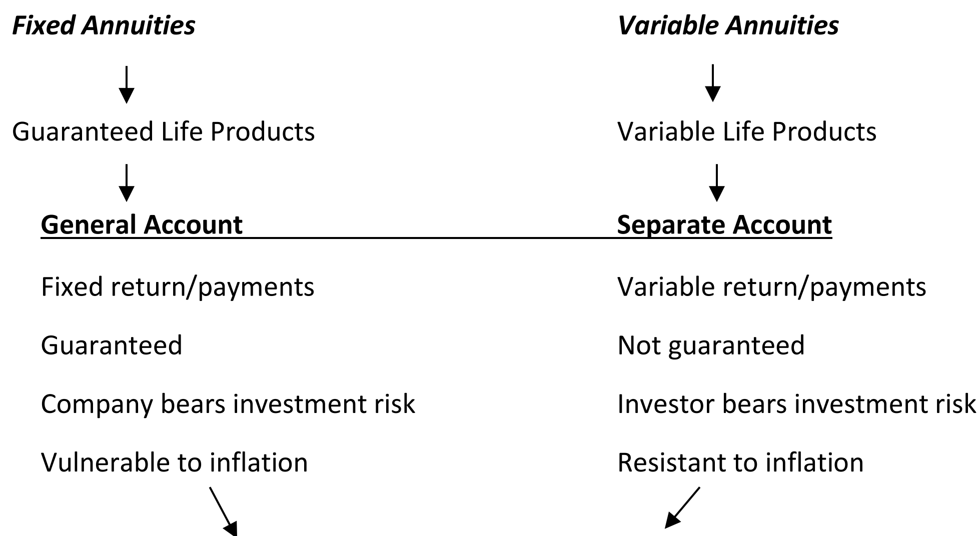
Generally, the payment amount is adjusted and any amounts overpaid are charged against the next payments made to the payee. Any amounts underpaid are added to the next payment. The company sometimes reserves the right to collect from the payee any amounts overpaid.

Section VI – Fixed vs. Variable Annuity Contracts

<u>Insurance Company Separate Accounts and General Accounts</u>

The contract holder bears the investment risk in variable contracts such as variable annuities and variable life insurance policies. Because the insurance company is not sustaining the investment risk of the contract, the underlying assets of the contract cannot be kept in the insurance company's **general account.** These assets must be held in a *separate account.*

<u>Insurance Company</u>



Fixed Annuity and Variable Annuity Common Characteristics

- Guaranteed payments for life
- Tax-deferred earnings
- Professional Management
- Lose control of principal upon annuitization

Investment Company Act of 1940 **....**The Investment Company Act of 1940 defines the **separate account** as an account established and maintained by the insurance company under which income, gains and losses are credited to or charged against the account without regard to other income, gains or losses of the insurance company.

The separate account in a variable contract is a securities-related product, must be registered under the **Securities Act of 1933,** and must be sold by means of a prospectus. The prospectus must include all material information required in order for the investor to make an informed investment decision. This information includes the following:

- The securities held in the account
- Policies for transferring between different investment selections
- Sales charges and other expenses

The separate account for a variable annuity must also be registered under the Investment Company Act of 1940, unless the account is used to fund a tax-qualified annuity, in which case the account is exempt under the act.

Assets held in the separate account are managed by a board of managers. The insurance company's investment manager maintains a different objective for the general account versus the separate account. The **general account** is fundamentally invested **in long-term debt instruments,** with the primary objective of providing a **stable return** for the account.

- The investment policies of the **separate accounts** are **detailed in the prospectus.** Many separate accounts have a growth-oriented objective and invest mainly in common stocks. The objectives of the separate account are **not guaranteed.**

Annuitant Suitability

Since there is such a fundamental difference in the risk and return characteristics of fixed and variable annuities, each type is more or less suitable for various purposes. However, some form of annuity would be indicated in the following circumstances:

1) When a tax deferred accumulation of interest is desired. The interest earned inside an annuity owned by an individual grows income tax free and is not taxed until it is withdrawn.
2) When liquidity is desired. Owners may usually withdraw cash before the annuity starting date.
3) When an investment with immediate and high collateral value is wanted.
4) When a person wants a retirement income that can never be outlived.
5) When the person would like to avoid probate and pass a large sum of money by contract to an heir to reduce the possibility of a will contest.
6) When an investor wants to be free of the responsibility of investing and managing assets.
7) As a replacement for or an alternative to an Individual Retirement Account (IRA). With less opportunity for pre-tax contributions to IRAs, many clients are seeking opportunities to make regular after-tax contributions to an investment vehicle.

Fixed annuities, in particular, are indicated:

- When safety of principal is a paramount consideration. This is particularly important for retirement planning.
- When an investor wants a guarantee that a given level of interest will be credited to his investment for a long period of time.
- When a conservative complement to other investment vehicles is desired.

Variable annuities, in particular, are indicated:

- When an investor wants more control over his investment and is willing to bear the risk associated with his investment selections.
- When a person is looking for potentially increasing retirement income.

Advantages

1) An annuity protects and builds a person's cash reserve. The insurer guarantees principal, interest, and the promise (if purchased) that the annuity can never be outlived. This makes the annuity particularly attractive to those who have retired and desire or require fixed monthly income and lifetime guarantee.
2) A client can time the receipt of income and shift it into lower income tax bracket years. This ability to decide when to be taxed allows the annuitant to compound the advantage of deferral.
3) The guarantees of safety, interest rates, and life-long income give the purchaser peace of mind and psychological security.
4) Given the same rate of interest, the annuity will produce more capital more quickly than a taxable investment because the effective yield will be higher.

Disadvantages

1) Receipt of a lump sum at retirement could result in a significant tax burden.
2) A long term cash flow stream of a fixed amount may not keep pace with inflation.
3) A 10 percent penalty tax is generally imposed on withdrawals of accumulated interest prior to age 59 $^{1/2}$ or disability.
4) If an annuity contract is held by a corporation or other entity that is not a natural person, the contract is not treated as an annuity contract for federal income tax purposes. This means that income on the contract for any taxable year is treated as current taxable ordinary income to the owner of the contract regardless of whether or not withdrawals are made.
5) If the client is forced to liquidate the investment in the early years of an annuity, management and maintenance fees and sales costs could prove expensive. Total management fees and mortality charges can run from one to two percent of the value of the contract. There may be a "back-end" surrender charge if the contract is terminated within the first few years to compensate the insurer for the sales charges which are not typically levied "up front."

Comparison of Fixed and Variable Annuities

	Fixed	**Variable**
Payments	Provides fixed payments of specified amount for the contract term	Provides variable dollar payments at regular intervals for the contract term
Rate of Return	Guarantees a minimum rate of return	Provides no guaranteed rate of return
Risk	Insurance company assumes the investment risk	Annuitant assumes all investment risk

The annuity contract specifies that deposits be made into the contract, either in a lump sum or through a series of periodic installments. In return for the monies deposited, the contract will provide income payments for the remaining lifetime of the annuitant or according to the terms of the specific payout option chosen by the owner.

Most annuities are offered by insurance companies; however, some broker-dealers also directly offer annuities. It is important to note that an annuity is a life insurance product and requires a **life insurance license** (which includes the sale of annuities).

Variable annuities also require a securities license in addition to the insurance license.

The payments an annuitant receives from a **fixed annuity** remain constant for the life of the contract. The performance of the insurance company's investment portfolio has no effect on the payments made to the annuitant. The annuitant is **guaranteed** a minimum rate of return, which is stated in the contract. In other words, the **insurance company accepts all investment risks** with the assets deposited into the plan and is fully responsible for all gains or losses respective to the annuity contract.

A fixed annuity affords the annuitant a guaranteed income that he cannot outlive. The annuitant also benefits from professional management of the assets on deposit in the contract through the insurance company. A disadvantage of a fixed annuity is that the **fixed payout does not keep up with inflation.** As inflation rises, the purchasing power of the fixed payments is eroded.

With a **variable annuity,** the payments made by the issuer to the annuitant **vary in dollar amount in accordance with the performance of the separate account.** There is **no guarantee** with a variable annuity, and the **annuitant assumes all investment risks** of the portfolio.

The person receiving the payments is known as the **annuitant** and typically receives the payments at retirement, but may annuitize at any time according to the terms of the contract.

<u>Contract Holder Objective</u>: **The annuitant's objective with a variable annuity is to be provided with a lifetime income that will likely keep up with inflation.** Historically, common stocks have, over time, produced returns that keep pace with rises in the cost of living. Because the issuer invests the monies in the separate account into a securities portfolio that consists mainly of common stocks, the annuity provides the opportunity to keep up with inflation.

<u>Types of Variable Annuities</u>**:** Variable annuities are classified by when their annuity payments begin. The two classifications are **immediate annuities** and **deferred annuities.**

An ***immediate annuity*** **(liquidation phase)** is funded only with a single lump sum payment because the contract begins making payments to the annuitant on the first interval after the deposit is received. The annuity income amount is based upon the annuitant's life.

- If the payments are to be monthly, the annuitant will begin to receive payments 1 month after the deposit is made.
- If the annuitant has chosen an annual payment, the first payment will be received 1 year after the deposit.

For example: Eddie's wife Harriet died at age 69 leaving a $200,000 death benefit to Eddie. Eddie decides to use this $200,000 and purchase a single premium immediate annuity. He gives the $200,000 to the insurance company and chooses a yearly payment mode. One year after the $200,000 was received by the insurance company, Eddie starts receiving an installment based upon this annuity payment option.

A ***deferred annuity*** is an annuity that either is purchased with a single, lump sum (single premium-deferred annuities) or is purchased through periodic payments (flexible premium-deferred annuities). In a deferred annuity, **payout is delayed** until the contract is annuitized at some point in the future. This period may be several years, **often at retirement**.

<u>Some characteristics of deferred annuities are</u>:

- Tax-deferred growth
- Income payments begin sometime after one year from the date of purchase (10 years, 20 years, at age 65, etc.)
- Often used to accumulate funds for retirement
- The owner will receive the current interest rate or the guaranteed interest rate, whichever is higher

A deferred annuity has a guaranteed surrender value that is available if the owner decides to surrender the annuity prior to annuitization. If a deferred annuity is surrendered prior to the owner's age 59 $^{1/2}$, income tax must be paid on the gain, in addition to a 10% penalty on the taxable portion.

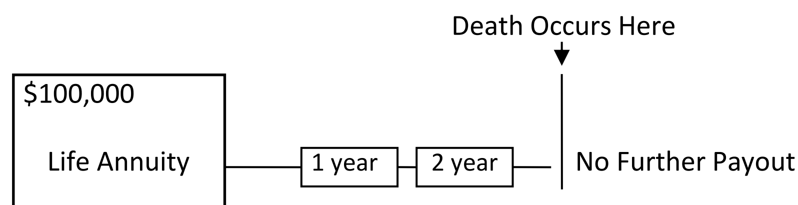
Annuity Settlement/Liquidation Options:

The annuitant has several payment options from which to select when he or she is ready to receive benefit payments from the annuity contract. The selection of the settlement option is made at the beginning of the payout period.

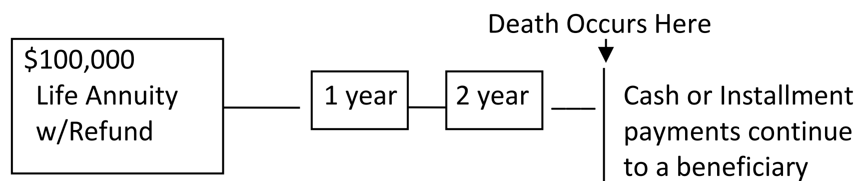
The life settlement options include:

- **Pure or straight <u>life annuity</u> —** This option gives the annuitant the **highest periodic payment** but carries the **most risk.** The annuitant receives payments as long as he or she lives. Upon the annuitant's death, all payments end. Therefore, if the annuitant dies after receiving only one payment, no other payments will be made.

  <u>There is no beneficiary</u>.



- **Unit refund <u>life annuity</u> —** This option provides periodic payments during the annuitant's lifetime. If the annuitant dies prior to receiving an amount equal to the value of the annuity units, the remaining portion will be paid in a lump sum or installments to the beneficiary.



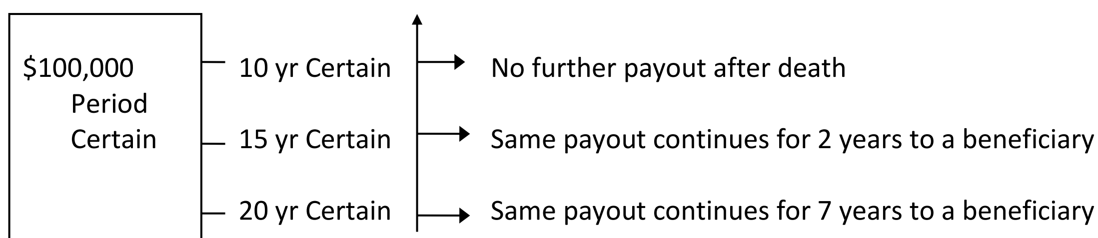
  - a.k.a. ***Cash Refund*** or ***Installment Refund Annuity***

- **Joint and last survivor <u>life annuity</u> —** With this option, payments are made to 2 people. If one annuitant dies, payments continue to be made to the surviving annuitant. All payments cease when the remaining person dies.

- **<u>Life annuity</u> with period certain (fixed period) —** With this settlement option, periodic payments are made to the annuitant for a specified number of years (usually 10 or 15). If the annuitant dies before the end of the period, the remaining payments due will be made in a lump sum or in installments to the named **beneficiary.**

  For example, if an annuitant has a life with 10-year period certain annuity and dies after receiving payments for 13 years, the beneficiary will not receive anything. If the annuitant dies after receiving payments for 13 years from a life with 15-year period certain option, the beneficiary will receive payments for an additional 2 years.

<u>If death to the annuitant occurs after 13 years of payouts</u>



- **Designated or Fixed Time —** This option is useful for anticipated expenses of a certain length of time, such as college expenses. Payments are based on a designated principal and are arranged to be exhausted after a predetermined number of installments. For example, say Mr. X chooses a 20 Period Certain option. This option will pay equal installments of an amount that will exhaust the principal and interest during the fixed period (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.

- **Designated or Fixed Amount Option -** 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 Mrs. 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, Mrs. B would not receive any further benefits from the annuity contract. In the event of Mrs. B's death before the funds in the annuity have been used up, the remainder generally is paid to her ***beneficiary***.

- **Combined fixed and variable annuity payout —** This is a combination of guaranteed fixed dollars for a base income and variable dollars as a hedge against inflation. The percentage of each payment is designated in the contract.

Contractual Annuity Provisions

Mortality Guarantee: The annuity company guarantees that it will make payments as long as the annuitant lives through a **mortality guarantee.** The insurance company deducts a **mortality expense risk fee** from the separate account to protect itself against an annuitant outliving their expected mortality.

Expense Guarantee: Annuity companies are required to project their administrative expenses for annuity contracts. The **expense guarantee** establishes the maximum they can charge the contract. The annuity company is responsible for any increase in expenses beyond the amount guaranteed in the contract. An **operating expense risk fee** is deducted from the separate account to protect the company against rising operating expenses.

Death Benefit: Annuity contracts also have a provision for a **benefit** in the event the contract owner dies during the accumulation period; the beneficiary will then receive the greater of the gross payments made into the contract or the accumulated value at the time of the owner's death.

Surrender Value: An annuity can be terminated anytime during the accumulation period for its **surrender value,** which is the current value of the assets held in the separate account less any surrender charges. No termination, either whole or in part, can occur once annuity payments have begun.

Exchange Privilege: **Loan provisions, partial redemptions,** and **exchange privileges** during the accumulation period are outlined in the contract when applicable. A "1035 exchange" allows a tax-sheltered exchange from one annuity contract to another under certain conditions.

Sales Charges and Expenses: Variable annuity contracts have sales charges that are similar to those of mutual funds. FINRA conduct rules have established that the maximum allowable sales charge on a variable annuity contract is **8.5%** over the life of the contract. The sales charge is delineated to pay for sales and marketing expenses, administrative expenses and may also include a minimum death benefit refund.

- All variable annuity contracts that are funded by a specific separate account are subject to the **same sales charge,** regardless of whether the annuity is funded by a single premium or with periodic installments. Any **breakpoints and rights of accumulation** available to the contract owner are established in the **prospectus.**

Level Sales Charge: Variable annuities can be sold on a level sales charge, or **level load,** basis. Level sales charges are deducted from each installment made into the contract.

<u>Deferred Sales Charge</u>: Annuities can also be offered with a **deferred sales charge** to cover the operating expenses and commissions associated with the contract. Under the deferred sales charge method, the charge to the contract owner is usually contingent on the length of time that the annuity is held, and is assessed at withdrawal.

The following is an *example* of a typical deferred sales charge:

Year of Withdrawal after Purchase	Withdrawal (deferred sales) Charge
First	6%
Second	5%
Third	4%
Fourth	3%
Fifth	2%
Sixth	1%
Seventh	0%

<u>Other Acquisition Costs</u>: The sales charge is made up of several elements, which are designated in the prospectus. An annuity has other expenses that are not part of the sales charge. These expenses are **deducted from the assets or income of the separate account.** These additional expenses include the following:

There are five fees or charges which are often incurred in annuities, particularly in variable annuities. In a survey of eight large insurance companies, the fees include:

1) ***Investment Management Fees*** … from a low of .25% to a high of .75%.
2) ***Administration Expense and Mortality Risk Charges …*** from a low of 1% to a high of 1.3%.
3) ***Annual Maintenance Charge*** … from $0 to $100.
4) ***Charge Per Fund Exchange*** … from $0 to $10.
5) ***Maximum Surrender Charge*** … from 5% of premium decreasing to 0% over 9 years to 8% of premium decreasing to 0% over 8 years.

Valuation of a Variable Annuity Contract

The value of a variable annuity is expressed in units, with the unit values determined by the performance of the separate account. The value of the portfolio in the separate account is recalculated each business day at the close of the New York Stock Exchange. During the time that the owner is depositing money into the contract, the annuity's valuation is expressed in an **increasing** number of **accumulation units.** When the payout period begins and the annuitant receives benefit payments, the annuity's valuation is expressed in a **fixed** number of **annuity units.**

Separate Accounts

The **accumulation unit** is the accounting measure used to identify the contract owner's interest in the separate account during the accumulation period. The **accumulation period** begins with the date on which the annuity contract becomes effective and continues until the payout period begins

The value of each accumulation unit is directly related to the performance of the separate account. As the value of the separate account increases or decreases, the value of each accumulation unit increases or decreases in proportion to the number of total units issued in the separate account.

Accumulation units are purchased at the separate account's NAV, after deducting any sales charges or other fees. New accumulation units are purchased using forward pricing in the same manner as mutual fund shares are acquired. An annuitant's interest in the separate account is determined by multiplying the number of accumulation units owned by the value of each accumulation unit. *For example,* an annuitant with 1,000 accumulation units valued at $6.00 per unit would have an interest in the separate account valued at $6,000.

Section VII – (Equity) Indexed Annuity Contracts

What Is An Indexed Annuity?

An indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides 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 the S&P 500, which is an equity index.

The value of any equity index varies from day to day and is not predictable. When you buy a fixed indexed annuity you own an insurance contract. You are not buying shares of any stock.
An indexed annuity is different from other fixed annuities because of the way it credits interest to your annuity's value. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurer.
Indexed Annuities credit interest using a formula based on changes in the index to which the fixed indexed annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest you get and when you get it depends on the features of your particular fixed indexed annuity.

Annuity Products

Immediate fixed annuities are insurance products that provide immediate income for a pre-determined period of time such as for the life of the contract holder or a specified number of years. Payments promise a set regular amount based on a certain interest rate.

Immediate variable annuities provide immediate income for a pre-determined period of time.
Unlike immediate fixed annuities, the payments may increase or decrease based on performance of underlying investments the purchaser selects.

Deferred fixed annuities have an accumulation, or investment, phase as well as the option of a payout/ income, phase. There may be a one-time purchase or a series of purchases made over time. Payments from this annuity for a set regular amount are to begin in the future rather than immediately. An example of a variation on this type is a deeply deferred annuity, also known as commercial "longevity insurance," which may begin payments starting after a late age, such as 85.

Deferred variable annuities have an accumulation and potentially a payout phase where the accumulation and regular payments may vary based on performance of underlying investments the purchaser selects. The payout phase may feature fixed or variable payments.

Indexed annuities offer a return computed by reference to (but not necessarily the same as) an outside index such as the S&P 500 Composite Stock Price Index, often promising a minimum contract value regardless of index performance.

Annuities with guaranteed living benefits frequently offer optional features that provide various protections or guarantees, subject to certain restrictions. For example, a minimum withdrawal benefit provides for periodic withdrawals of a specified percentage of the investment (e.g., 5% to 7%) and further provides that the insurance company will continue payments of that amount if the account is depleted by reason of permitted withdrawals and/or investment performance. These withdrawals generally will continue until the original investment has been recouped or, in the case of a so-called "lifetime withdrawal benefit," for the life of the contract owner.

Equity-Indexed Annuities

A Complex Choice

Sales of **equity-indexed annuities (EIAs)**—also known as "fixed-indexed insurance products" and "indexed annuities"—have grown considerably in recent years. Although one insurance company at one time included the word "simple" in the name of its product, EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there is not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another.

What is an Equity-Indexed Annuity?
EIAs are complex financial instruments that have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. EIAs give you more risk (but more potential return) than a fixed annuity but less risk (and less potential return) than a variable annuity.

EIAs offer a minimum guaranteed interest rate combined with an interest rate linked to a market index. Because of the guaranteed interest rate, EIAs have less market risk than variable annuities. EIAs also have the potential to earn returns better than traditional fixed annuities when the stock market is rising.

What is the Guaranteed Minimum Return? When EIAs were first sold in the mid-1990s, the guaranteed minimum return was typically 90 percent of the premium paid at a 3 percent annual interest rate. More recently, in part because of changes to state insurance laws, the guaranteed minimum return is typically at least 87.5 percent of the premium paid at 1 to 3 percent interest. However, if you surrender your EIA early, you may have to pay a significant surrender charge and a 10 percent tax penalty that will reduce or eliminate any return.

How good is this guarantee? Your guaranteed return is only as good as the insurance company that gives it. While it is not a common occurrence that a life insurance company is unable to meet its obligations, it happens. There are several private companies that rate an insurance company's financial strength. Information about these firms can be found on the SEC's website.

What is a market index? A market index tracks the performance of a specific group of stocks representing a particular segment of the market, or in some cases an entire market. For example, the S&P 500 Composite Stock Price Index is an index of 500 stocks intended to be representative of a broad segment of the market. There are indexes for almost every conceivable sector of the stock market. Most EIAs are based on the S&P 500, but other indexes also are used. Some EIAs even allow investors to select one or more indexes.

How is an EIA's index-linked interest rate computed? The index-linked gain depends on the particular combination of indexing features that an EIA uses. The most common indexing features are listed below. To fully understand an EIA, make sure you not only understand each feature, but also how the features work together since these features can dramatically impact the return on your investment.

- **Participation Rates …** A participation rate determines how much of the gain in the index will be credited to the annuity. For example, the insurance company may set the participation rate at 80 percent, which means the annuity would only be credited with 80 percent of the gain experienced by the index.
- **Spread/Margin/Asset Fee …** Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10 percent and the spread/margin/asset fee is 3.5 percent, then the gain in the annuity would be only 6.5 percent.

- **Interest Rate Caps …** Some EIAs may put a cap or upper limit on your return. This cap rate is generally stated as a percentage. This is the maximum rate of interest the annuity will earn. For example, if the index linked to the annuity gained 10 percent and the cap rate was 8 percent, then the gain in the annuity would be 8 percent.

Caution! Some EIAs allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features.

Indexing Methods … As described in the table below, there are several methods for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index.

Indexing Method	Description
Annual Reset (Rachet)	Compares the change in the index from the beginning to the end of each year. Any declines are ignored. **Advantage:** Your gain is "locked in" each year. **Disadvantage:** Can be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.
High Water Mark	Looks at the index value at various points during the contract, usually annual anniversaries. It then takes the highest of these values and compares it to the index level at the start of the term. **Advantage:** May credit you with more interest than other indexing methods and protect against declines in the index. **Disadvantage:** Because interest is not credited until the end of the term, you may not receive any index-linked gain if you surrender your EIA early. It can also be combined with other features such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.
Point-to-Point	Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term. **Advantage:** May be combined with other features, such as higher cap and participation rates, that may credit you with more interest. **Disadvantage:** Relies on a single point in time to calculate interest. Therefore, even if the index that your annuity is linked to is going up throughout the term of your investment, if it declines dramatically on the last day of the term, then part or all of the earlier gain can be lost. Because interest is not credited until the end of the term, you may not receive any index-linked gain if you surrender your EIA early.

Index Averaging … Some EIAs average an index's value either daily or monthly rather than use the actual value of the index on a specified date. Averaging may reduce the amount of index-linked interest you earn.

- **Interest Calculation …** The way that an insurance company calculates interest earned during the term of an EIA can make a big difference in the amount of money you will earn. Some EIAs pay simple interest during the term of the annuity. Because there is no compounding of interest, your return will be lower.

- **Exclusion of Dividends …** Most EIAs only count equity index gains from market price changes, excluding any gains from dividends. Since you are not earning dividends, you won't earn as much as if you invested directly in the market.

A Few Common Questions:

… Can I get my money when I need it? EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

- Any withdrawals from tax-deferred annuities before you reach the age of 59½ are generally subject to a 10 percent tax penalty in addition to any gain being taxed as ordinary income.

… Do EIAs and other tax-deferred annuities provide the same advantages as 401(k)s and other before tax retirement plans?

No, 401(k) plans and other before-tax retirement savings plans not only allow you to defer taxes on income and investment gains, but your contributions reduce your current taxable income. That's why most investors should consider an EIA and other annuity products only after they make the maximum contribution to their 401(k) and other before-tax retirement plans. To learn more about 401(k)s, please read Smart 401(k) Investing.

… **Is it possible to lose money in an EIA?** Yes. Many insurance companies only guarantee that you'll receive 87.5 percent of the premiums you paid, plus 1 to 3 percent interest. Therefore, if you don't receive any index-linked interest, you could lose money on your investment. One way that you could not receive any index-linked interest is if the index linked to your annuity declines. The other way you may not receive any index-linked interest is if you surrender your EIA before maturity. Some insurance companies will not credit you with index-linked interest when you surrender your annuity early.

Section VIII – Taxation of Qualified and Non-Qualified Annuities

Tax Implications

1. A client's investment in an annuity is returned in equal tax-free amounts during the payment period. Any additional amount received is taxed at ordinary income rates. This means part of each payment is considered return *of* capital and is therefore nontaxable and ***part of each payment is considered return on capital (income) and is therefore taxable at ordinary rates***.

The formula for determining the nontaxable portion of each year's payout is:

$$\frac{\text{Investment in the Contract}}{\text{Expected Return}}$$

Exclusion ratio: It is expressed as a percentage and applied to each annuity payment to find the portion of the payment that is excludable from gross income. For instance, assume a 70-year-old purchases an annuity. He pays (the investment in the contract) $12,000 for the annuity. Assume his expected return is $19,200.

The exclusion ratio is $12,000/$19,200, or 62.5%. If the monthly payment he receives is $100, the portion that can be excluded from gross income is $62.50 (62.5% of $100). The $37.50 balance of each $100 monthly payment is ordinary income.

The full amount of each annuity payment received is tax free if the investment in the contract exceeds the expected return.

The excludable portion of any annuity payment may not exceed the unrecovered investment in the contract (unless the annuity started before January 1, 1987). The "unrecovered investment in the contract" is the policy owner's premium cost (reduced by any dividends received in cash or used to reduce premiums and by the aggregate amount received under the contract on or after the annuity starting date to the extent it was excludable from income). This rule limits the total amount the policy owner can exclude from income to the total amount of his contribution. Once an annuitant actually lives longer than his actuarial life expectancy, 100% of each payment will be taxable.

Some annuities provide a refund if the annuitant dies before recovering his entire cost, or provide a "period-certain" guarantee (payments will be made for a specified period regardless of how long the annuitant lives). The value of the refund or period-certain guarantee must be ascertained by government tables and subtracted from the investment in the contract.

The **expected return** is the total amount that the annuitant (or annuitants) should receive given the payments specified, multiplied by the life expectancy according to the government's tables (currently Table V for single lives and Table VI for joint and survivor annuities). For instance, under Table V, a 70-year-old has a life expectancy of 16 years. If he (or she, since the life expectancy tables are unisex) receives $100 a month, the expected return would be $19,200 ($1,200 a year x 16 years).

2. When an annuitant dies before receiving the full amount guaranteed under a refund or period certain life annuity, the beneficiary receiving the balance of the guaranteed amount will have no taxable income unless the amount received by the beneficiary plus the amount that had been received tax free by the annuitant exceeds the investment in the contract.

   If the refund or commuted (present) value of the remaining installments is applied by the beneficiary to purchase a new annuity, payments received will be taxed under the annuity rules to the beneficiary. The refund amount will be considered the beneficiary's investment in the new contract and a new exclusion ratio must be determined.

3. If the annuitants were receiving payments under a joint and survivor annuity and one of the annuitants dies, the survivor excludes from income the same percentage of each payment that was excludable before the death of the first annuitant. An income tax deduction may be available to the survivor annuitant to the extent inclusion of the annuity in the estate of the first to die generated an estate tax. A similar deduction may be available if the annuity generated a generation skipping transfer tax.

4. When an annuitant makes a partial withdrawal from the contract and takes a reduced annuity for the same term, a portion of the amount withdrawn will be subject to tax.

5. When an annuitant makes a partial withdrawal from the contract (allocable to an investment in the contract made after August 13, 1982) and chooses to take the same payments for a different term, to the extent the cash surrender value of the contract exceeds the investment in the contract, gain will be realized in the form of a taxable withdrawal of interest."

6. The purchaser of a variable annuity is not taxed on income during the accumulation period. No tax will be payable until the earlier of the surrender of the contract or the time payments under the annuity begin (the "annuity starting date"). To obtain annuity treatment, however, the underlying investments of the segregated asset account must be "adequately diversified" according to IRS regulations.

   Payments made as an annuity under a variable annuity are not subject to the same exclusion ratio as is a regular fixed annuity. This is because it is impossible to determine the expected return.

7. Amounts payable under a deferred annuity contract at the death of an annuitant (prior to the contract's maturity) will be taxed as ordinary income to the beneficiary. The excess of (a) the death benefit (plus aggregate dividends and other amounts that were received tax free) over (b) total gross premiums is taxable.'

   Beneficiaries can elect to delay reporting of the gain in the year of the annuitant's death if the beneficiary applies the death benefit under a life income or installment option within 60 days of the annuitant's death.' The beneficiary will then report income according to an exclusion ratio. The beneficiary's investment in the contract will be the same as the decedent's investment in the contract. The expected return is based on the income the beneficiary will receive and the beneficiary's life expectancy.

8. The owner of an annuity often takes dividends, makes cash withdrawals, or takes other amounts out of the annuity contract before the date the annuity is to start (the "annuity starting date"). Such amounts are taxable as income to the extent that the policy cash value exceeds the investment in the contract. The so called "interest first" rule (amounts received are treated first as interest income and further amounts are considered a recovery of cost) was imposed to discourage the use of annuity contracts as short term investment vehicles. Under this rule, a loan is considered a cash withdrawal.

   Likewise, to the extent the contract is used as collateral for a loan, amounts borrowed will be taxable (to the extent the amount received equals or is less than any gain inherent in the contract). If the amount received exceeds the built-in gain, the excess of what was borrowed over potential gain is considered a tax free return of the contract owner's investment. With respect to contracts entered into after October 21, 1988, amounts borrowed increase investment in the contract to the extent they are includable in income under these rules.

   In applying the interest first rule, all contracts entered into after October 21, 1988 and issued by the same company to the same policyholder during any calendar year are treated as one contract.

9. "Premature" distributions are subject not only to the normal tax on ordinary income, but also to a penalty tax of 10%.

   The penalty for premature distributions will **not apply** to any of the following:

   - payments which are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of the taxpayer
   - payments made on or after the time the taxpayer becomes age 59 1/2
   - payments made on account of the taxpayer's disability
   - payments made from qualified retirement plans and IRAs (but these are subject to other similar premature distribution requirements)
   - payments made to a beneficiary (or annuitant's estate) on or after the death of an annuitant
   - distributions under an immediate annuity contract
   - an annuity contract purchased on the termination of certain qualified employer retirement plans and held until the employee separates from service

10. If an annuity owner dies before the starting date of the annuity payments, the cash value of the contract must either be distributed within 5 years of death or used within one year of death to provide a life annuity or installment payments payable over a period not longer than the beneficiary's life expectancy. However, if the surviving spouse is the beneficiary, the distribution requirements are applied by treating the spouse as the owner of the annuity contract.

    The 10% premature distribution penalty tax does not apply to required after-death distributions.

    If an annuity contract issued after April 22, 1987, is transferred by gift, the tax deferral on the inside build up that was allowed to the original contract owner is eliminated. The donor of the gift is treated as having received non-annuity income in an amount equal to the excess of the cash surrender value of the contract at the time of the transfer over the investment in the contract at that time.

11. Tax free build-up within the contract is allowed only to "natural persons." If an annuity contract is held by a person who is not a natural person, then the annuity contract is not treated as an annuity and the income on the contract is treated as ordinary income received or accrued by the owner during that taxable year.

    Corporations are not "natural persons." Neither is the typical trust although a trust acting as the agent for a natural person would itself be considered a natural person. But if an employer is the agent for its employees, the contract will be considered as if owned by the employer. The employer will therefore be taxed on the inside buildup. This means annuities are no longer appropriate tax advantaged investments for nonqualified deferred compensation agreements.

    Exceptions from the "natural person" rule allows tax free build-up of the following:

    - annuities received by the executor of a decedent at the decedent's death
    - annuities held by a qualified retirement plan or IRA
    - annuities considered "qualifying funding assets" (used to provide funding for structured settlements and by property or casualty insurance companies to fund periodic payments for damages)
    - annuities purchased by an employer on termination of a qualified plan and held until all amounts under the plan are distributed to the employee or his beneficiary
    - annuities which are "immediate," (i.e., those which have a starting date no more than one year from the date the annuity was purchased and provide for a series of substantially equal periodic payments to be made at least annually over the annuity period).

Section IX – Primary Uses of Annuities

Retirement

How long could you maintain a comfortable lifestyle if you no longer had any earned income? Could you manage for as long as 20 or 30 years, or even longer if necessary?

People need to be able to answer "yes" to that question if they hope to retire someday. For many people, retirement won't be just a 10- or 15-year period. People are living longer. Not only are more people living to retirement age; people are living longer *after they have retired.*

According to current annuity mortality tables, three out of five individuals age 65 today can be expected to live to age 85. Two out of five will live to age 90. One out of five will live another 30 years to age 95.

That is a wonderful thing, of course—unless your money runs out. Accumulating an adequate retirement fund and making it last for the remainder of your nonworking life calls for planning carefully and making wise choices about financial vehicles.

For virtually anyone, annuities can fulfill an important role in retirement planning. While an individual is still working, concern about retirement focuses on accumulating an adequate retirement fund. Worries about inflation, job security in the wake of corporate downsizing, and uncertainty about the future of Social Security are giving new impetus to individuals' concerns about having adequate savings for retirement.

Tax-Deferral

Annuities offer a number of benefits as retirement savings vehicles. One of their most important benefits is tax-deferral. Tax-deferred funds accumulate to greater amounts over the years compared to funds on which tax must be paid each year. This is the result of what is sometimes referred to as "triple compounding." That is, interest is earned on:

- principal
- interest
- dollars that would otherwise have been paid in taxes

Although dollars on which no tax has yet been paid will eventually be taxed when they come out of the contract, deferring taxation increases the effect of interest compounding during the period of deferral. Because of tax-deferral, annuities have a long-term growth advantage over vehicles whose earnings are taxable each year, such as bank accounts and CDs.

A particular advantage that variable annuities have over mutual funds, thanks to tax-deferral, is the fact that switching funds among investment options does not create a tax liability. One of the advantages of equity mutual funds is that they can accumulate unrealized capital gains, which are not currently taxed.

When mutual fund investors move their money from one fund to another, even within the same fund family, they must pay tax on any appreciation in the value of their shares. When variable annuity owners transfer their money between investment options, however, any appreciation in the value of their account remains tax-deferred until money is taken out of the annuity.

Fund transfers might be made for a number of reasons:

- In accordance with an asset re-balancing or dollar-cost averaging program
- To attempt to achieve a better return in a different investment option
- To change the portfolio mix when ones investment objectives have changed, for example when one retires and wants to assume less risk

Whatever the reason, moving your money is a taxable event with a mutual fund, but not with a variable annuity.

Annuities Offer a High Degree of Safety

Fixed annuities offer a guarantee against investment risk. Fixed annuity values do not fluctuate the way stocks, bonds, or mutual fund shares do. A dollar credited to a fixed annuity will always be worth a dollar—more than a dollar, with interest.

With variable annuities, the purchaser assumes the investment risk. However, the separate account is protected against the claims of creditors.

The financial affairs of insurance companies that issue annuities are closely regulated by the states to ensure that these companies will be able to meet their obligations to their annuity owners. State financial regulation of insurance companies has a number of aspects.

- First, insurance companies must meet **capital and surplus requirements** in order to obtain their initial license to do business in a state and to continue doing business in that state. These requirements ensure that an insurance company has and maintains a given amount of net worth—that is, assets over and above liabilities.

- Insurance companies are required to maintain **liability reserves.** Liability reserves, the amounts of which are established by the states, assure that an adequate proportion of an insurance company's assets is set aside and earmarked specifically for meeting the financial obligations the company has assumed toward its annuity contract holders and other policy owners.

- Insurance companies must also maintain **asset valuation reserves,** which are designed to cover the risk of defaults on the stocks, bonds, real estate, and mortgages in a company's general account portfolio. An insurer with lower-quality assets is required to maintain a higher amount of asset valuation reserves.

- Insurance companies are **limited in the types of investments they may make in their general account.** State regulations require a large proportion of insurance company general account portfolios to be invested in what are usually thought of as conservative assets such as bonds and mortgages rather than more speculative investments such as stock.

Guaranty Association

Most states have established **guaranty funds.** In the rare instance when an insurance company does become insolvent, guaranty funds help make up the difference between the assets a company has left and the amounts it owes to its annuity contract holders and other policy owners, up to certain limits ***($500,000 in cash value or present value of future benefits payable on any one life, in the State of Washington)***. Unlike the deposit insurance on bank and savings and loan accounts, guaranty funds are funded by the insurance industry itself and not from tax dollars.

Note: in some states (including the State of Washington) it is illegal for an agent to disclose the existence of a guaranty fund for marketing purposes.

An insurer's financial strength can also be evaluated by consulting ratings given by independent rating services. A few of the major rating services for insurers include, but are not limited to:

- M. Best Company
- Standard & Poor's
- Moody's Investors Service

These firms analyze an insurer's financial condition and rate it on a scale ranging from superior to poor. Not all the services rate every company, but most companies will be rated by at least one service and many companies are rated by two or more. The ratings are updated on a regular basis to reflect changes in an insurer's financial condition.

Performance

In terms of performance, fixed annuities are often compared to other interest-bearing financial vehicles, and variable annuities are often compared to mutual funds. Such comparisons are far from being "apples to apples," since annuities have features (such as the death benefit and the potential for a lifetime income stream) that other financial vehicles do not possess. Agents need to address these unique features with their prospects and clients during the sales process, because these features are important parts of the product the individual is buying. Nevertheless, earnings rates are a factor that consumers look at closely in making a purchase decision.

Other Uses of Annuities

Although the primary purpose of an annuity is to play an accumulation and income-generation role in retirement planning, there are a number of other ways that annuities can be used to meet people's financial needs in certain situations. By understanding how the unique features of annuities can be utilized in these other situations, you will increase the value of the services you offer to your customers and the public.

Split Funding

Split-funding can be useful for people who have a need to generate spendable income over a certain number of years, but also want to preserve their capital. The term "split-funding" is derived from the fact that a sum of capital is split into two single-premium annuity payments. One of the premiums purchases a deferred annuity, the accumulated value of which will equal the original capital amount after a certain number of years. The other premium purchases an immediate annuity that generates largely tax-free income over that same period. By generating income *and* restoring the original capital amount over a period of years, split-funding allows annuity owners to eat their cake and have it, too, to a certain extent.

To explain split-funding, let's look at an example. Let's say that Kristina has retired from full-time employment at age 55. She'll still be working part-time, but she wants to have some supplemental income for the next seven years until she can begin Social Security retirement benefits at age 62. She has $100,000 in savings which she could draw on for income, but she's afraid of spending her principal.

One option Kristina would have is to buy a seven-year certificate of deposit. Let's say that seven-year certificates of deposit are currently paying 4% interest. If Kristina bought a seven-year certificate of deposit, it would preserve her $100,000 and provide her with $4,000 per year of income over the next seven years. However, that interest income from her certificate of deposit would be fully taxable. If Kristina is in the 15% federal income tax bracket, she would have only $3,400 of spendable income after federal income taxes.

Since interest rates on annuities are often higher than those being offered on certificates of deposit, another option Kristina might have is to utilize an annuity to generate interest income. Let's say you could offer Kristina an annuity paying 5% over the next seven years. Kristina would withdraw the $5,000 in interest that her $100,000 annuity fund would generate each year, and after paying taxes in her 10% federal income tax bracket, she would realize $4,500 of spendable income each year. Although Kristina is withdrawing her interest earnings and therefore not obtaining any benefit from tax-deferral, the higher interest rate available on the annuity provides her with $500 more spendable income each year compared to the certificate of deposit.

While split-funding creates a tax-advantaged income stream for a limited number of years, it also converts a portion of nontaxable principal to interest accumulations on which income taxes will be due when those accumulations are paid out of the contract. No income taxes are currently due as long as the accumulations remain inside the contract. But the interest-out-first rule limits the usefulness of split-funding to create an income stream beyond the initial split-funding period.

For example, if Kristina needed continued current income and withdrew money from her deferred annuity to purchase another immediate annuity, the tax treatment of this subsequent series of immediate annuity payments would not be as favorable at that shown above for the initial split. That's because the money Kristina withdrew from her deferred annuity would have to come first from her taxable interest accumulations. If the entire amount withdrawn came from taxable interest accumulations, there would be no cost basis with which to calculate an exclusion ratio. In such a case, the entire amount of the second series of immediate annuity payment would be taxable.

Using Annuities for Long-Term Care Insurance

Once an individual's need for long-term care insurance has been established, the major roadblock to obtaining adequate coverage is often affordability. Annual premiums for long-term care insurance policies generally range from $1,500 to $5,000. How can an individual ensure that, along with all of his or her other needs for income, up to $5,000 will be available to pay the long-term care insurance policy premium every year for as long as he or she lives—especially after the individual has retired and no longer has income from employment?

- One answer would be to *set aside* a sum of money in a safe, interest-bearing investment such as a certificate of deposit and pay the long-term care insurance policy premium from the interest it generates. But this tactic has a number of problems.

- One problem is that it ties up a huge sum of capital. If certificates of deposit were paying 4%, it would take a fund of $125,000 to generate the needed $5,000 each year.

- Another problem is that interest rates on certificates of deposit change from time to time. If interest rates on certificates of deposit fell to 3.5%, the fund would generate only $4,375. The $625 shortfall that year would have to be made up from income earmarked for other purposes.

Finally, as long as the fund is generating income, it is also generating an income tax liability. In the 10% tax bracket, the individual would have a $500 federal income tax liability on the $5,000 of interest earnings used to pay the long-term care insurance policy premium. In the 27% tax bracket, the annual federal income tax liability would be $1,350.

A better alternative would be to purchase a single-premium immediate annuity that would generate the necessary premium amount each year for as long as the individual lived. *The older the individual is, the less such an annuity would cost.* A prospect age 60 might be able to purchase an annuity that would guarantee $5,000 of income for life for about $85,000—$40,000 less than the amount of capital required to be tied up using the interest income from a certificate of deposit to pay the long-term care insurance policy premium. At age 65, the same single-premium annuity could be purchased for about $67,000.

The annuity would be guaranteed to generate the necessary premium amount, nothing less. And, because of the exclusion ratio, the annuity payment is largely tax-free during the period of the individual's life expectancy. If the individual lived past his or her life expectancy so that all of the premium was considered to have been returned to him or her, annuity payments would become fully taxable from that point on.

Another alternative for funding long-term care insurance policy premiums with annuities involves split-funding in connection with long-term care insurance policies that become paid-up after a certain number of years. For example, if you sold a long-term care insurance policy that became paid-up after 10 equal annual premium payments, you could sell a 10-year single-premium immediate temporary annuity in an amount sufficient to pay those 10 premiums. At the same time, you could sell a deferred annuity whose accumulations in 10 years would match the amount paid for the single-premium immediate annuity.

Annuities and Estate Planning - Avoiding Probate

Probate is the process that ensures that the assets in a deceased individuals' estate are distributed in accordance with the law. It can be a lengthy process, and assets are not distributed to heirs until the process is complete. The soonest an estate can be settled is generally six to nine months after the date of the decedent's death. If disputes arise or if an estate has a large number of assets or assets that are difficult to value, the probate process can go on for years.

<u>Steps in the Probate Process</u>

1. If the deceased left a will, the probate court must verify its validity. If the deceased died *intestate* (that is, the individual left no will or a will that is invalid), the estate will generally be divided among the surviving spouse and children in proportions described in the state's intestacy laws.

2. If there is a will, it is read and persons who wish to contest it must be heard.

3. If the will is valid, the executor named in the will is appointed to take charge of the estate. If there is no valid will or the named executor is not available, the court appoints an administrator.

4. The executor or administrator makes an inventory of the estate's assets and liabilities, including taxes.

5. Appraisers may be called in to help establish the value of estate assets.

6. The executor or administrator pays the estate's outstanding debts and taxes due.

7. Remaining assets are distributed to the heirs according to the terms of the will or the state's intestacy laws.

The probate process can also be costly. Attorneys' fees are generally based on the size and complexity of the estate. A larger estate stands to have more of its assets consumed by probate costs. Probate is also a public process, though it often deals with matters that many people would prefer to keep private.

One of the advantages of annuities is that their values are excluded from an individual's probate estate (though not from the individual's taxable estate). Annuity values pass to the beneficiary by the terms of the annuity contract at the owner's death. Annuity values therefore avoid the delays, expense, and publicity of probate. In addition, they are not made available to pay outstanding debts owed to the creditors of the deceased individual's estate.

The value of an annuity is generally includible in an individual's estate for estate tax purposes. However, while many types of annuities continue to have value after the death of an individual, there is one type of annuity which no longer has any value once the annuitant dies: the life-only annuity. Therefore, it is possible to reduce the size of an individual's taxable estate by purchasing a life-only annuity with assets that would otherwise be included in the individual's estate. Using assets to purchase life-only annuities not only reduces the size of the taxable estate, but also creates a tax-advantaged income stream that is guaranteed to continue to the annuitant for life.

The drawback is that the assets used to purchase the life-only annuity will no longer be available to be distributed to heirs upon the individual's death. In cases where an individual has a desire to pass the value of an asset on to heirs, a variation of this idea may be used whereby a portion of the annuity income is used to fund an irrevocable life insurance trust designed to remain outside the individual's estate. The beneficiary of the trust is the intended heir. When the annuitant dies, the life insurance proceeds paid to the trust replace the value of the asset that was used to purchase the life-only annuity.

This strategy removes an asset from the individual's taxable estate while creating another asset that can be left to the heir. To the extent that the income from the life-only annuity is greater than the amount required to fund the trust, this strategy also creates tax-advantaged income to the individual for life.

Business Planning

Business planning opportunities with annuities are somewhat limited by the "non-natural person" rule that makes interest earned on annuities taxable to corporations. Life insurance plays an important role in many business planning situations—for example, funding buy-sell agreements and executive bonus (Section 162) plans. If a business principal or key employee is uninsurable, annuities may be a suitable alternative funding instrument for such plans. However, because of the non-natural person rule, it is generally desirable to arrange for an individual involved in the plan to own the annuity so that earnings within the contract can accumulate on a tax-deferred basis.

Annuities are also useful as retirement planning instruments. Sole proprietors and partners may wish to purchase annuities individually using funds from their businesses to plan for their retirement. Annuities are also suitable funding instruments for employer-sponsored qualified retirement plans (you may recall that qualified plans are one of the exceptions to the non-natural person rule).

College Funding

Generally, annuities are not considered to be suitable for short-term funding needs such as saving for a college education because of the surrender charges imposed by many annuity contracts and the 10% penalty tax on premature withdrawals. However, there are certain limited situations where surrender charges and the penalty tax pose no barrier to college funding.

For example, some individuals have children relatively late in life. A child that is born when an individual is age 42 or older will probably not begin college until after the individual is age $59^{1/2}$. In such a case, annuity funds could be used to pay for college expenses without incurring the 10% penalty tax on premature withdrawals. At the same time, contract surrender charges could be avoided if, for example, the surrender charge declined over a period of years from the initial contract date and the annuity was purchased far enough in advance.

Section X – Sales Practices, Replacement, and Disclosure Requirements

Washington Law: The **Free Look (Return of Policy)** law gives the policy owner a ***minimum*** of 10 days to examine the policy from the date it is ***received by the policy owner***. **All premium** must be refunded within 30 days or the insurance company must pay an additional 10% penalty to the owner should the policy be returned.

This Free Look (Return of Policy) law DOES NOT apply to individual life insurance policies:

- issued in connection with a ***credit transaction*** (aka Credit Life Insurance)
- issued under a ***contractual policy change*** (such as changing a whole life to a universal life)
- issued using the ***conversion privilege*** provision contained in a policy (such as converting a term life to a whole life)

Washington Law: Replacement Regulation

"Conservation" means any attempt by the existing insurer or its agent or by a broker to try to dissuade a policy owner from cancelling their insurance policy or annuity to replace it with a new one. Conservation does not include such routine administrative procedures as late payment reminders, late payment offers or reinstatement offers.

"Direct-response sales" means any sale of life insurance or annuities where the insurer does not utilize a producer in the sale or delivery of the policy.

"Existing insurer" means the insurance company whose policy is or will be changed or terminated in such a manner as described within the definition of "replacement."

"Existing life insurance or annuity" means any life insurance or annuity in force, including life insurance under a binding or conditional receipt or a life insurance policy or annuity that is within an unconditional refund period.

"Replacing insurer" means the insurance company that issues or proposes to issue a new policy or contract which is a replacement of existing life insurance or annuity.

The purpose of the **replacement regulation** is to regulate activities of insurance companies and producers with respect to the replacement of existing life and annuity contracts; to protect the interests of the purchaser by establishing minimum standards of conduct; to assure that the purchaser receives information with which a decision can be made in his or her own best interest; and to reduce misrepresentation.

The replacement regulation requires that a Notice Regarding Replacement of Insurance form be completed by the producer when a new life or annuity application is written and an existing policy is either lapsed, terminated or surrendered.

- **Violation of this code is considered twisting**.

- **The form makes the insured aware of certain areas which may be of concern should an existing policy be replaced**.

Following a Replacement:

- The replacing insurance company has three days after receipt of the application or the date the policy is issued, whichever is sooner, to send the necessary forms, including a Policy Summary, about the new proposed policy, to the existing insurer, along with the Notice of Replacement.
- The existing insurer must try to save (conserve) the replaced policy. Conservation means any attempt by the existing insurer or producer to dissuade a policy owner from replacing an existing life insurance policy or annuity.
- The replacing insurer must provide information in its policy or in a separate written notice which is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid, which right may be exercised within 20 days commencing from the date of delivery of the policy.

Transactions Exempted from the Replacement Law:

- Policy Conversions (within the same company, term to perm)
- Credit Life, all Variable Contracts (a.k.a. a Registered Contract), Group Life and Group Annuities
- Life Insurance within Employee Pension Plans (subject to ERISA, the Employee Retirement Income Security Act of 1974 [Federal guidelines])
- Replacing life insurance or annuities issued by the same company writing the new policy. For example, a producer for Allstate is replacing an in-force Allstate life insurance policy with a new Allstate life insurance policy.

Duties of Producers During Replacement:

- Present the applicant with the notice of replacement, signed by the producer and the insured, and leave the original with the insured.
- Obtain a list of all existing insurance identified by the name of insurer, insured, and contract or policy number.
- Leave the applicant the written or printed items used in the presentation.
- Submit a copy of the replacement notice to the insurer.

Replacement: Tax-Free "1035" Exchanges

Section 1035 of the U.S. tax code allows you to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in your current variable annuity account. These tax-free exchanges, known as 1035 exchanges, can be useful if another annuity has features that you prefer, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices.

You may be required to pay surrender charges on the old annuity if you are still in the surrender charge period. In addition, a new surrender charge period generally begins when you exchange into the new annuity. This means that, for a significant number of years (as many as 10 years), you typically will have to pay a surrender charge (which can be as high as 9% of your purchase payments) if you withdraw funds from the new annuity. Further, the new annuity may have higher annual fees and charges than the old annuity, which will reduce your returns.

Caution!
If you are thinking about a 1035 exchange, you should compare both annuities carefully. Unless you plan to hold the new annuity for a significant amount of time, you may be better off keeping the old annuity because the new annuity typically will impose a new surrender charge period. Also, if you decide to do a 1035 exchange, you should talk to your financial professional or tax adviser to make sure the exchange will be tax-free. If you surrender the old annuity for cash and then buy a new annuity, you will have to pay tax on the surrender.

Disclosure of Charges and Fees:
Bonus Credits…Some insurance companies are now offering variable annuity contracts with "bonus credit" features. These contracts promise to add a bonus to your contract value based on a specified percentage (typically ranging from 1% to 5%) of purchase payments.

> **Example:** You purchase a variable annuity contract that offers a bonus credit of 3% on each purchase payment. You make a purchase payment of $20,000. The insurance company issuing the contract adds a bonus of $600 to your account.

Frequently, insurers will charge you for bonus credits in one or more of the following ways:

1) Higher surrender charges – Surrender charges may be higher for a variable annuity that pays you a bonus credit than for a similar contract with no bonus credit.

2) Longer surrender periods – Your purchase payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit.

3) Higher mortality and expense risk charges and other charges – Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays you a bonus credit. Although the difference may seem small, over time it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.

Before purchasing a variable annuity with a bonus credit, ask yourself – and the financial professional who is trying to sell you the contract – whether the bonus is worth more to you than any increased charges you will pay for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long you hold your annuity contract, and the return on the underlying investments. You also need to consider the other features of the annuity to determine whether it is a good investment for you.

Example: You make purchase payments of $10,000 in Annuity A and $10,000 in Annuity B. Annuity A offers a bonus credit of 4% on your purchase payment, and deducts annual charges totaling 1.75%. Annuity B has no bonus credit and deducts annual charges totaling 1.25%. Let's assume that both

annuities have an annual rate of return, prior to expenses, of 10%. By the tenth year, your account value in Annuity A will have grown to $22,978. But your account value in Annuity B will have grown more, to $23,136, because Annuity B deducts lower annual charges, even though it does not offer a bonus.

You should also note that a bonus may only apply to your initial premium payment, or to premium payments you make within the first year of the annuity contract. Further, under some annuity contracts the insurer will take back all bonus payments made to you within the prior year or some other specified period if you make a withdrawal, if a death benefit is paid to your beneficiaries upon your death, or in other circumstances.

Caution!
If you already own a variable annuity and are thinking of exchanging it for a different annuity with a bonus feature, you should be careful. Even if the surrender period on your current annuity contract has expired, a new surrender period generally will begin when you exchange that contract for a new one. This means that, by exchanging your contract, you will forfeit your ability to withdraw money from your account without incurring substantial surrender charges. And as described above, the schedule of surrender charges and other fees may be higher on the variable annuity with the bonus credit than they were on the annuity that you exchanged.

Example: You currently hold a variable annuity with an account value of $20,000, which is no longer subject to surrender charges. You exchange that annuity for a new variable annuity which pays a 4% bonus credit and has a surrender charge period of eight years, with surrender charges beginning at 9% of purchase payments in the first year. Your account value in this new variable annuity is now $20,800. During the first year you hold the new annuity, you decide to withdraw all of your account value because of an emergency situation. Assuming that your account value has not increased or decreased because of investment performance, you will receive $20,800 minus 9% of your $20,000 purchase payment, or $19,000. This is $1,000 less than you would have received if you had stayed in the original variable annuity, where you were no longer subject to surrender charges.

In short: Take a hard look at bonus credits. In some cases, the "bonus" may not be in your best interest.

WAC 284-17-605 Use of Senior Designation

1) The purpose of this section is to set forth standards to protect consumers from misleading and fraudulent marketing practices with respect to the use of senior specific certifications and professional designations in the solicitation, sale or purchase of, or advice made in connection with a life insurance or annuity product. *Consumers are misled and harmed when insurance producers use designations and certifications that imply the existence of a level of expertise in senior affairs and financial matters that, in fact, does not exist*.

2) It is an unfair or deceptive practice for an insurance producer to use a senior-specific certification or professional designation that indicates or implies in such a way as to mislead a purchaser that the insurance producer has special certification or training in advising or servicing seniors in connection with the solicitation, sale, or purchase of a life insurance or annuity product or in the provision of advice as to the value of or the advisability of purchasing or selling a life insurance or annuity product, either directly or indirectly through publications or writings, or by issuing or promulgating analyses or reports related to a life insurance or annuity product.

3) <u>The prohibited use of senior-specific certifications or professional designations includes, but is not limited to, the following</u>:

- a) Use of a certification or professional designation by an insurance producer who has not actually earned or is otherwise ineligible to use such certification or designation;
- b) Use of a nonexistent or self-conferred certification or professional designation;
- c) Use of a certification or professional designation that indicates or implies a level of occupational qualifications obtained through education, training or experience that the insurance producer using the certification or designation does not have; and
- d) Use of a certification or professional designation that was obtained from a certifying or designating organization that:

  - i) Is primarily engaged in the business of instruction in sales or marketing;
  - ii) Does not have reasonable standards for assuring the competency of its certificants;
  - iii) Does not have reasonable standards or procedures for monitoring and disciplining its certificants or designees for improper or unethical conduct; or
  - iv) Does not have reasonable continuing education requirements for its certificants.

4) An <u>**exception**</u> to the prohibited use of senior-specific certifications or professional designations, in the above subsection 3) d) is when the certification or designation issued is from an organization that has been accredited by:

- a) The American National Standards Institute (ANSI)
- b) The National Commission for Certifying Agencies
- c) Any organization that is on the U.S. Department of Education's list entitled "Accrediting Agencies Recognized for Title IV Purposes"

5) In determining if a combination of words, or an acronym standing for a combination of words, constitutes a certification or professional designation indicating or implying that a person has special skill, knowledge, experience or qualifications in advising or servicing seniors, factors implying such include, but are not limited to, the following:

Use of the word "senior," "retirement," "elder," or similar words combined with one or more words such as "certified," "registered," "chartered," "advisor," "specialist," "consultant," "planner," or similar words in the name of the certification or professional designation; and the manner in which those words are combined.

6) For purposes of this section, a job title within an organization that is licensed or registered by a state or federal financial services regulatory agency is not a certification or professional designation, unless it is used in a manner that would not confuse or mislead a reasonable consumer, when the job title indicates seniority or standing within the organization or
specifies an individual's area of specialization within the organization.

WAC 284-23-240 General rules.

1) Each insurer must maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use under this regulation. The file must contain one copy of each authorized form for **a period of three years** following the date of its last authorized use unless otherwise provided by this regulation.

2) An insurance producer must inform the prospective purchaser, prior to commencing any presentation that may lead to the sale of life insurance, that the insurance producer is acting as an insurance producer with a life insurance line of authority. In sales situations in which an insurance producer is not involved, the insurer must identify its full name.

3) Terms such as financial planner, investment advisor, financial consultant or financial counselor must not be used by an insurance producer unless the insurance producer is engaged in an advisory business and receives a substantial part of their compensation from that source unrelated to the sale of insurance.

4) There must be no reference to a dividend or nonguaranteed element in the policy summary. Any reference to a dividend or a nonguaranteed element in the sales process must
comply with the provisions of chapter 48.23A RCW.

5) Any statement regarding the use of the life insurance cost comparison indexes must include an explanation to the effect that the indexes are useful only for the comparison of the
relative costs of two or more similar policies.

WAC 284-23-360 General Rules.

1) Each insurer must maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file must contain one copy of each authorized form for a period of at least **three years** following the date of its last authorized use.

2) An insurance producer must inform the prospective purchaser, prior to commencing a sales presentation, that the insurance producer is acting as an insurance producer with a life insurance line of authority and must inform the prospective purchaser of the full name of the insurer which the insurance producer is representing. In sales situations in which an insurance producer is not involved, the insurer must identify its full name.

3) Terms such as financial planner, investment advisor, financial consultant, or financial counselor must not be used by an insurance producer unless the insurance producer is engaged in an advisory business and receives a substantial part of their compensation from that source unrelated to the sale of insurance.

4) Any reference to dividends or to excess interest credits must include a statement that such dividends or credits are not guaranteed.

5) A presentation of benefits must not display guaranteed and nonguaranteed benefits as a single sum unless guaranteed benefits are shown separately in close proximity thereto and with equal prominence.

6) Sales promotion literature and contract forms must not state or imply that annuity contracts or deposit funds are the same as savings accounts or deposits in banking or savings institutions.

Ask Questions Before You Invest

Before you decide to buy a variable annuity, consider the following questions:

Will you use the variable annuity primarily to save for retirement or a similar long-term goal?

Are you investing in the variable annuity through a retirement plan or IRA (which would mean that you are not receiving any additional tax-deferral benefit from the variable annuity)?

Are you willing to take the risk that your account value may decrease if the underlying mutual fund investment options perform badly?

Do you understand the features of the variable annuity?

Do you understand all of the fees and expenses that the variable annuity charges?

Do you intend to remain in the variable annuity long enough to avoid paying any surrender charges if you have to withdraw money?

If a variable annuity offers a bonus credit, will the bonus outweigh any higher fees and charges that the product may charge?

Are there features of the variable annuity, such as long-term care insurance, that you could purchase more cheaply separately?

Have you consulted with a tax adviser and considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on your tax status in retirement?

If you are exchanging one annuity for another one, do the benefits of the exchange outweigh the costs, such as any surrender charges you will have to pay if you withdraw your money before the end of the surrender charge period for the new annuity?

Websites That May Be Helpful:

FINRA — The Financial Industry Regulatory Authority is an independent self-regulatory organization charged with regulating the securities industry, including sellers of variable annuities. FINRA has issued several investor alerts on the topic of variable annuities, and has also issued a release to its members giving guidance on how to present information on the impact of taxes upon investment returns in a variable annuity as compared to a non-specific taxable account. If you have a complaint or problem about sales practices involving variable annuities, you should contact the District Office of FINRA nearest you. A list of FINRA District Offices is available on FINRA's web site.

National Association of Insurance Commissioners (NAIC) — The NAIC is the national organization of state insurance commissioners. Variable annuities are regulated by state insurance commissions, as well as by the SEC. The NAIC's web site contains an interactive map of the United States with links to the home pages of each state insurance department. You may contact your state insurance commissioner with questions or complaints about variable annuities.

How To Contact the SEC With Questions or Complaints

Office of Investor Education and Advocacy
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0213
Fax: (202) 772-9295
Questions: Fast Answers
Online Complaint Form

http://www.sec.gov/investor/pubs/varannty.htm

Section XI – Common Annuity Questions and Answers

<u>What are the various types of annuities currently available</u>?

Answer — Annuities can be classified according to:

Premium Payment Method… Single premium annuities are commonly used when a person receives a large cash amount such as from an inheritance, from the sale of a business or a large piece of real estate, or from a qualified pension or profit-sharing plan lump-sum distribution and the person has no plans to make additional contributions.

Fixed premium contracts are popular with investors who do not have the resources to pay a single premium and who desire a "forced savings" feature. Typically, fixed annual premium payments continue until the desired annuity starting date. Since the annual premiums are fixed, the total accumulation and, therefore, the ultimate annuity payout, is very predictable.

Flexible premium contracts permit the contract owner to make premium contributions whenever desired and in any desired amount. Generally, no minimum annual premium payments are required, except in the first few years of the contract.

Disposition of Proceeds… Contract owners may choose to have annuity payouts continue only as long as one or more annuitants survive if they elect a life annuity with no refund feature. Under this option, payments are assured for the life or lives of the annuitant or annuitants, but once the annuitant(s) dies, annuity payments cease, even if the total paid out of the annuity is less than the amount invested in the contract.

Since many investors are reluctant to forfeit a portion of their investment in the event of the premature death of the annuitant, annuity contracts may offer minimum payback guarantees, regardless of when the annuitant dies. These guarantees take two forms. Refund annuities promise to pay, either in a lump-sum cash payment or in the form of an installment payout, the difference between the amount invested in the contract (generally the total of the premiums paid) and the annuity payments actually paid out before the death of the annuitant. Period certain annuities promise to make payments for a stipulated period, such as 5, 10, or 20 years, or for the annuitant's life, whichever is longer.

The payout period may also be short-term. Term certain annuities are similar to a loan amortization. A specified amount is payable for the stipulated term only, regardless of when the annuitant dies. A temporary annuity is a variation on the period certain annuity concept. However, instead of paying a specified amount for the ***longer*** of the annuitant's life or the stipulated term, a temporary annuity continues payments only for the ***shorter*** of the annuitant's life or the stipulated term.

Date Benefits Begin… An immediate annuity starts annuity payouts immediately after premiums are contributed. Immediate annuities are commonly used when a person wishes to convert a large lump-sum amount, frequently a lump-sum distribution from a qualified pension or profit-sharing plan, into an income stream payable immediately. As the term suggests, deferred annuities begin paying the annuity sometime after premiums have been contributed.

Number of Lives Covered… The annuity payout period may depend on one, two, or, less commonly, more lives. In the case of annuities based on two or more lives, payouts may continue until the last annuitant dies — a joint and last survivor annuity — or until the first death — a joint life annuity. In the common two-life joint and survivor annuity, the amount payable to the survivor after the first death may be some specified percentage (called the survivor benefit ratio) of the amount payable while both annuitants live. Commonly elected percentages are 100, 75, 66, and 50 percent. For example, if the joint benefit is $20,000 per year, a joint and 50% survivor annuity would pay $10,000 per year to the survivor after the first death.

The benefit payable to the survivor may also depend on which annuitant dies first. In its conventional form, a joint and survivor annuity has a principal annuitant and a secondary annuitant or beneficiary. The survivor benefit ratio applies only to the benefit payable to the surviving secondary annuitant after the principal annuitant's death. If the principal annuitant survives the secondary annuitant, the benefit payments are not reduced.

Investment Options… Fixed rate annuity contracts are like universal life policies in that amounts credited to cash values are based on the insurer's current declared rate, which may be guaranteed for one to five years. Fixed rate contracts guarantee a minimum interest rate. The current rate declared by the insurer depends on the performance of the general investment portfolio of the company, which is predominantly invested in fixed income investments such as bonds and mortgages. Therefore, interest credits depend on market rates on these types of fixed-income investments but the cash values themselves are not market valued.

In contrast, variable annuities are like variable insurance policies. The contract owner may choose to have premiums and cash values invested in a wide array of investment options or separate accounts. The amount credited to cash values and the value of the cash value account itself depends on market values of the assets in the separate accounts. In other words, in return for bearing the risk of investment and foregoing minimum interest rate guarantees, variable annuity contract owners are given the flexibility to choose their investment portfolio and the opportunity to earn greater total returns than those earned on fixed rate annuities.

Benefit Payments… The annuity benefit payments may be fixed or variable. Fixed annuities guarantee a minimum annuity benefit payment per dollar of accumulated value, similar to settlement options under life insurance policies. Annuity benefit payments from variable annuities fluctuate with the market value of the assets in the separate accounts and are not guaranteed.

What happens to the money paid to the insurance company when the annuitant dies?

Answer— A "pure life annuity" is one in which the continuation of payments by the insurer is contingent upon the continuing existence of one or more lives. The consideration (premium) paid for the annuity is fully earned by the insurer immediately upon the death of the annuitant. This is why annuities payable for the life or lives of one or more annuitants frequently include a minimum payment guarantee. In other words, many annuities include both life and fixed period or refund elements so that if death occurs prematurely, the annuitant and the annuitant's survivors will recover a total of at least a minimum amount. Therefore, each annuity payment where a minimum guarantee has been purchased is composed of (a) return of principal, (b) interest or earnings on invested funds, and (c) a survivorship element.

If an annuitant dies before having recovered the full amount guaranteed under a refund or period certain life annuity, the balance of the guaranteed amount is not taxable income to the refund beneficiary - until the total amount received tax free by the annuitant plus the total amount received tax free by the beneficiary equals the investment in the contract. From that point on, all additional amounts received are ordinary income."

<u>What is the difference between a "fixed" annuity and a "variable" annuity</u>?

Answer — Although annuities have many other distinguishing features, the two major types of annuities being sold today are the fixed annuity and the variable annuity. About 90% of all outstanding annuity contracts fall into the fixed rate category, but variable annuities are becoming increasingly popular. The investment account in a fixed rate contract operates much like the cash value account of a universal life policy. The annuity investment earns a fixed rate (at the date of this printing about 5 to 7 percent) which is guaranteed for the first one to five years of the contract. After that time, the rate depends on the investment success of the insurer's general portfolio (subject to a guaranteed floor, typically about 4%).

In many fixed rate contracts, if the contract return falls below that minimum rate, there is often a "bailout rate." Once the return falls below the bailout rate, which is often 1% below the guaranteed minimum rate, the contract owner can terminate the contract without cost. The fixed rate contract gives the contract owner no choice or say in the underlying investments.

Variable rate annuities are becoming increasingly popular because, in return for the assumption of greater risk, the contract owner may obtain both greater investment flexibility and a higher return. The contract owner can select from among a number of separate accounts that are similar to mutual fund investments. The investment options typically include diversified stock, bond, and money market funds. Most insurers also now offer a broad array of alternative funds such as specialized stock funds (sector funds, small-capitalization stock funds, index funds), foreign stock and bond funds, junk bond funds, real estate equity and mortgage funds, and asset-allocation funds (where the company's investment manager selects portfolio weights allocating investments among the other funds).

<u>What is the difference between a joint annuity and a joint and last survivor annuity</u>?

Answer — A joint life annuity is a contract that provides a specified amount of income for two or more persons named in the contract. Income ends upon the first death. A joint and last survivor contract is much more popular because payments continue until the last death among the covered lives. Obviously, this form of annuity is more expensive than other forms since, on average, it will pay income for a longer time. This increased cost is reflected in a lower income than would be paid under a single life annuity at either of the two ages.

Clients can purchase the joint and survivor annuity on either a pure life basis (ending at the later death) or with a certain number of payments guaranteed. Most insurers offer a form of joint and survivor annuity that pays the full amount while both annuitants are alive and then two thirds or one half that income when the first annuitant dies. This is called a "joint and two thirds" or "joint and one half' annuity.

<u>How does the variable annuity work</u>?

Answer— The variable annuity was the product of a search for a tool which would provide a guaranteed lifetime income that could never be outlived that also provided a relatively stable purchasing power in times of inflation. The variable annuity is based on equity type investments.

Variable annuity premiums are paid to the insurance company during the "accumulation period." That money is placed into one or more separate accounts. The funds in these accounts are invested separately from the other assets of the insurer. Each year, some money is taken out of the contract owner's premium for expenses. The balance is applied to purchase "units of credit" in the separate accounts.

The number of credits purchased depends on the current valuation of a unit in terms of dollars. For instance, if each unit was valued at $10 a unit based on current investment results, a $100 level premium (after expenses) would purchase 10 units. If the value of a unit dropped because of investment experience, the premium would purchase more units. If the value of a unit increases, the same premium would buy fewer units. This unit purchasing continues until the "maturity" of the contract.

At the maturity of the contract, the insurer credits the contract owner's total units to a retirement fund. A given number of accumulation units will purchase so many retirement income units (based on actuarial principals and upon the current value of each unit). Note that the variable annuity does not promise to pay a fixed number of dollars each month but rather a fixed number of annuity units. In other words, the dollar amount of each payment depends on the dollar value of an annuity unit when the payment is made. The dollar value of an annuity unit is in turn based on the investment results of the special account. For instance, assume an annuitant was entitled to a payment based on 10 annuity units each month. If the dollar value of an annuity unit varied from $12.10 to $12.50 to $12.80, the annuitant would be paid $121, $125, and $128.

<u>What are the risks being assumed by the contract owner under a variable annuity?</u>

Answer— Under a variable annuity, the insurer assumes only the risk of fluctuations due to mortality and expenses (guaranteeing that the annuitant will not outlive his income and that expense fluctuations will be absorbed). This means the contract owner is assuming the investment risk. If the special account is invested poorly or in the wrong investments, the annuitant will receive fewer dollars of income than would have been paid under a conventional fixed-dollar annuity.

Why, if payments from variable annuities depend on the market value of the underlying assets, do variable annuities have an assumed investment rate (AIR)?

Answer — Under most variable annuity contracts there is an assumed investment rate **(AIR)** that the investment portfolio must earn in order for benefit payments to remain level. If the investment performance exceeds that AIR, then the level of benefit payments will increase. On the other hand, if the investment performance falls below the AIR, then the level of benefit payments will decrease.

For example, assume you own a variable annuity contract that was issued with a 6% AIR and a beginning unit value of $20. You own 100 units. The investment yield during the first month in your contract was 12%; during the second month the investment yield was 4%. You can calculate the monthly benefit by monitoring the changes in the unit value and by comparing the actual performance with the assumed 6% interest rate. During the first month the 12% return on portfolio doubles the assumed 6% AIR and leads to a 6% increase in the $20 unit value. The new unit value is now $21.20 ($2,120 per month). During the subsequent month, because the actual return is only 4%, which is 2% less than the AIR, there will be a 2% reduction in the unit value to $20.77 ($2,077 per month). The unit value could actually drop below the beginning $20 value ($2,000 per month) if investment performance remains below the assumed 6% level for an extended period of time.

Can a person select the assumed interest rate (AIR) used to determine the initial benefit payments from a variable annuity and, if so, what impact will it have on the level of benefit payments?

Answer—Under some contracts the purchaser is able to select the AIR from a narrow range of possible rates. It is much easier to receive an increasing stream of benefit payments by selecting a lower AIR even though it is initially more expensive. The effect of choosing a different AIR can be demonstrated by returning to the example of the previous question.

If you had chosen an AIR of 8% rather than 6%, the benefit increase in the first month would have been 4% instead of 6%. The unit value would have changed to $20.80 instead of $21.20. The next month's decrease in benefits would have been more drastic, a 4% reduction rather than the 2% reduction. The unit value would have decreased to $19.96 instead of $20.77 from the lower **AIR.** By choosing the less costly higher AIR you will start with a higher initial benefit but you increase the likelihood that benefit payments will increase less rapidly and decrease more rapidly.

If you have a variable annuity, keep in mind that although variable annuity contracts are intended to provide a hedge against inflation and protect the purchasing power of the benefits, these increases have not always occurred at exactly the same time that prices increase. Often prices go up significantly before the level of benefits increases.

What is an FPDA?

Answer — An FPDA is a flexible premium deferred annuity. As the last two words indicate, the contract provides for the accumulation of funds to be applied at some future time designated by the contract owner to provide an income for the annuitant. Premiums can be paid as frequently or infrequently as the owner desires. They can be paid monthly, annually, or one or more years can be skipped since there is no specified contribution amount or required payment frequency. Most insurers do set a minimum payment level for administrative purposes, which typically runs from $25 to $50.

Most FPDA contracts have no front-end load. Annual loads vary but many are under $50 a year. Some companies charge loads based on a percentage of each contribution, as a percentage of the annuity fund balance, or as a percentage of both. The insurer does charge a "back-end" load (a surrender charge) when a cash withdrawal in a year exceeds a stipulated percentage of the fund balance. This load will typically reduce year by year to zero by the seventh or eighth contract year.

Insurers guarantee minimum interest rates but actually pay much higher rates. The actual rate will depend on the earnings rate of the insurer.

What is an SPDA?

Answer—An SPDA is a single premium deferred annuity. It provides, as its name implies, a promise that an annuity will begin at some time in the future in return for a single premium. A minimum stated rate of interest is guaranteed but most insurers pay competitive market rates.

The actual rate paid is a function of

- the current investment earnings of the insurer and
- how competitive the insurer is determined to be. The rate is subject to change by the insurer.

The SPDA, like the FPDA, is back-end loaded. No front-end charges are imposed. Surrender charges are graded and partial withdrawals are often allowed without charge. Bailout provisions allow the contract owner to withdraw all funds without the imposition of a surrender charge if the interest rate actually credited falls below the "bailout rate," which is typically set at the inception of the contract as 1% to 3% below the rate being credited at that time. Keep in mind that on any withdrawal there may be both an ordinary income tax and a penalty tax.