**THE BASICS OF ANNUITIES**

**What is an Annuity?**

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| The term annuity simply means a series of regular payments over time. In popular usage, however, annuity generally refers to a contractor policy, issued by an insurance company, providing for payment of a regular income by the annuity issuer to the owner, over a specified period or for the life of an annuitant*.* |

**How the Annuity is Purchased**

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| There are generally two different ways an annuity is purchased. A **Single Premium** annuity is a contract purchased with a single payment, or premium. No further premiums are required, or even allowable. A **Flexible Premium** annuity is purchased with an initial payment (to establish the contract) and typically contains a series of premiums that may be paid whenever, and in whatever amount, the purchaser wishes, subject to policy minimums and maximums.  There is very little difference, if any, in the important policy provisions, guarantees, and payout options of the two types, and their tax treatment is identical. The significant distinction is simply that in some instances, contracts offered as single premium cannot receive additional subsequent payments, and therefore do not allow additional contributions under the original contract’s terms—instead, additional money must be deposited to a new annuity contract. |

**When Annuity Payments Begin**

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| An **immediate annuity**is one in which regular income—or annuity—payments begin to be made to the owner1 within one year of purchase. Another label sometimes used to describe an immediate annuity is **payout annuity***.*  A **deferred annuity**is one in which annuity payments are deferred until later than one year after purchase—perhaps much later. The life of a deferred annuity is divided into two phases:   1. The **accumulation phase**. This is the period from purchase of the contract until annuitization. Annuitization is the exercise, by the owner, of a contractual option to begin receiving regular annuity payments, in accordance with an annuity payout option (see the section entitled “Types of Annuity Payouts”). Deferred annuity contracts typically require annuitization by some specified date or age by specifying a maximum annuity starting date or maturity date (e.g., policy anniversary following annuitant’s age 85, or annuitant’s age 85). Newer contracts may permit further deferral of annuitization provided the request is received within a specified period of time prior to the maturity date.   2.    The **distribution phase**. This is the period from annuitization until the annuity payments cease which may be at the end of the annuitant’s life or after a specified number of years.  *Note*:It is essential that the advisor understand the difference between an annuity contracts’s requiredannuity starting date (i.e., the date by which annuity payments must commence, absent an election to defer annuitization) and when annuitization is permittedunder that contract. In January, 2005, a class-action  lawsuit was filed alleging unsuitability, asserting that the deferred annuity purchased by a senior citizen allegedly did not permit annuity payments to begin until the annuitant’s age was 115. However, it appears that age 115 was the contract maturity date, and annuity payments under the contract could start at any time the owner wished to annuitize. In fact, in some contracts a late maturity date is a benefit, allowing an owner to keep the contract in the accumulation phase as long as possible.  There is no accumulation phasein the life of an immediateannuity, as annuity payments typically commence shortly after purchase, and must, by definition, commence within one year. Annuities that are in distribution phase (i.e., deferred annuities that have been annuitized and all immediate annuities) are said to be in payout status*.*  A third type of annuity, often called a **longevity annuity,**first appeared in the marketplace in 2007. It is similar to an immediate annuity in that it provides only for income (usually for life); there is no accumulation period. Unlike an immediate annuity, the longevity annuity income does not commence within one year of purchase; rather, it is deferred on until a future date, which is typically an advanced age such as age 85.  **How the Cash Value in the Annuity is Invested**   |  |  | | --- | --- | | A fixed annuity is an annuity in which the contract value is measured in dollars*.* A variable annuity is one in which the contract value is measured in terms of units—either accumulation unitsor annuity units, depending upon whether the contract is in the accumulation phaseor the distribution phase*.* In both cases, the value of each unit can—and probably will—vary each business day, according to the investment performance of the separate accounts chosen by the contract owner.  *Fixed Annuities*  In a fixed annuitythe contract values are guaranteed by the issuing insurance company. These values (discussed below) are all measured, as we’ve noted, in dollars*.* There is a common misconception that fixed, in the term fixed annuity, refers to the rate of interest credited to the contract. This is not correct. While some fixed deferredannuities provide guaranteesas to the periodduring which the currentinterest rate will be credited, and all deferred annuities provide a guaranteed minimuminterest rate that will be credited during the entire accumulation period, the term fixed, when used in reference to fixed annuities, properly refers, not to the interest rate, but to the fact that the contract values are measured in fixed units—namely, dollars.  What are these contract values? In a fixed immediateannuity, or a fixed deferredannuity that has been annuitized, the contract value guaranteed by the issuing insurer is the dollar amount of the periodic annuity payment (which may be payable monthly, quarterly, semi-annually, or annually). In a fixed deferredannuity, there are several contract values:   1. **Cash Value**.The cash value, or accumulation value, of a fixed deferred annuity is the value on which interest is computed and to which interest is credited. It is generally the sum of all premium payments received, plus all prior interest credited, less any withdrawals (and, in the case of certain qualified annuities, unpaid loan interest). The cash value of fixeddeferred annuities is always guaranteed. The cash value of variable annuities is not, except for monies deposited into the fixed account option of such contracts. 2. **Annuity Value**. The annuity valueis the value to which an annuity payout factorwill be applied if—and only if—the contract owner annuitizes the contract. In some deferred annuities, this value is identical to the cash value. In so-called tiered annuities (of the type where a higher interest rate is credited to the annuity value than is credited to the cash value) and in contracts providing for an annuitization bonus, the annuity value is higher than the cash value. 3. **Surrender Value**.The surrender valueof a deferred annuity is the cash value*,* less any applicable surrender chargeand market value adjustment, that will be paid to the contract owner upon surrender of the contract.   The basic investment difference between fixed and variable annuities is that in a fixed annuity, either immediate or deferred, the contract owner is offered no investment choices within the contract and assumes no investment risk. In a fixed deferredannuity, the cash value, which includes all premium payments and prior interest credited, is guaranteed against loss, as is a minimuminterest rate. All fixed deferred annuities also offer a current—nonguaranteed—interest rate. Some, but not all, contracts guarantee the current declared rate for a certain period of time.  It is essential for the advisor to understand that the guarantees in fixed annuities are only as good as the ability of the issuing insurer to pay them.  *Variable Annuities*  Variable annuities work very differently from fixed annuities, in both the accumulation phaseand in the distribution phase*.*  *The Accumulation Phase*  In the accumulation phase of a variable deferred annuity,4 each premium payment purchases, after applicable contract charges are deducted, a number of accumulation units for each investment subaccountchosen by the contract holder.  *Example:* Mr. Jones has chosen five investment subaccountsfrom among those available in his variable deferred annuity. He has directed that each premium payment5 be allocated to these accounts as follows:  Large Cap Growth Account 20%  Midcap Value Account 20%  Small Cap Value Account 20%  International Stock Acct 15%  Bond Account 25%  The accumulation unit valuesof these accounts on the day his premium is received are as follows:  Large Cap Growth Account $21,435  Midcap Value Account $16,567  Small Cap Value Account $34,123  International Stock Acct $9,567  Bond Account $15,003  If Mr. Jones makes a premium payment of $1,000, and the contract charges applicable are $14, the net premium ($986) will purchase:  Large Cap Growth Account 9.1999 units  Midcap Value Account 11.9032 units  Small Cap Value Account 5.7791 units  International Stock Acct 15.4594 units  Bond Account 16.4300 units  Accumulation unitvalues can, and often will, change each day according to the investment performance of the subaccounts, just as the net asset valueof a mutual fund share does. However, there is a significant difference between the pricing of annuity accumulation unitsand that of mutual fund shares. When a mutual fund declares a dividend or capital gains distribution—through the realization of dividends or capital gains income by the fund—and the shareholder has elected to reinvestsuch distributions, additional sharesare purchased for his account, and the price of all shares of the fund is reduced to reflect the distribution. If the shareholder has elected not to reinvest such distributions, he receives cash, and the share price is reduced. When a dividend or capital gain is realized by a variable annuity subaccount, the value of the accumulation unitis increased reflecting the dividend or gain received, but the number of units remains the same.  *Investment Subaccounts*  One of the main advantages of investing in a variable annuity is the access it provides to diversified investment types*.* The first variable annuities offered relatively few investment choices, and, often, the choices were limited to proprietaryaccounts; that is, accounts managed by the insurance company that issued the annuity, or a subsidiary. Many newer contracts offer subaccounts representing a wide variety of asset classes*,* managed by a variety of money management firms. Typically, the contract owner is permitted to choose several subaccounts, and to make exchanges among them—re-allocating existing contract values—and to reallocate ongoing contributions without charge. Moreover, exchanges among subaccounts in a single contract are not taxable events for income tax purposes. These investment management features, together  with features such as automatic portfolio rebalancing and dollar cost averaging from the annuity contract’s fixed account to the variablesubaccounts, make the modern variable annuity a robust and powerful investment management tool.  *The Distribution Phase*  In the distribution phase, fixed annuities—either immediate contracts or deferred contracts that have been annuitized—provide a regular income by application of a chosen annuity payout factor to the amount that is converted to an income stream. For example, if Mr. Smith purchases a fixed immediate annuity for $100,000 or annuitizes a fixed deferred annuity having an annuity value of that same amount, and if he elects aLife and 10 Year Certainpayout arrangement, and if the annual annuity payout factorfor that option, for his age and sex, is 5.67, his annuity payments will be $5,670 per year from that point until the later of his death or the expiration of 10 years. Similarly, if he elects to annuitize a variable deferred annuity on a fixedannuity payout arrangement, and if the total value of theaccumulation unitsin his contract, at the time of annuitization, is $100,000, he will receive that same income, assuming the same annuity payout factor.  If the annuity payout is to be on a variablebasis, however, the amount annuitized (either a lump sum, in the case of an immediate variable annuity, or, in a deferred variable annuity, the current value of the accumulation unitsthe owner wishes to annuitize11) is not converted to a fixed income stream by applying an annuity payout factor. Instead, the purchase payment or amount annuitized is used to buy a certain number of annuity units. The process works as follows:         - First, the payment, or annuitization amount, is reduced by any contract fee applicable and by any state premium taxdue, and allocated to the investment subaccountschosen by the contract owner         - Next, the insurance company computes an initial income payment amountfor that portion of the purchase payment or annuitization amount allocated to each subaccount, using (a) the age and sex  of the annuitant and (b) an assumed investment rate (AIR). Many variable annuity contracts allow the purchaser to choose among several AIRs (e.g., 3%, 4%, 5%, and 6%). The higher the initial AIR chosen, the higher the initial variable income payment will be.         -Finally, the initial income paymentis divided by the value of the annuity unit for each subaccount chosen. The result is the number of annuity unitsof that subaccount which will be purchased by that payment. Subsequent annuity payments will increase or decrease in proportion to the extent to which the net investment performance, after application of the separate account charges, of the chosen variable sub-accounts exceeds or lags the AIR.  **Types of Annuity Payouts**   |  | | --- | | An immediate annuity or a deferred annuity that has been annuitized — where the contract owner has elected to begin receiving annuity payments—produces an income stream***.*** The nature of this income stream can vary, according to the type of payout arrangement chosen.  The first arrangement, and the simplest, is **Life Only, No Refund**. When the contract owner elects this option, he or she will, upon annuitization, receive an income guaranteed to last for the annuitant’s entire lifetime—no matter how long that annuitant lives. At the annuitant’s death, no further payments will be due. Life Only, No Refund provides the highest payout of any of the annuity arrangements because if the annuitant dies prematurely—even if after receiving only one payment—the insurance company’s obligation ceases. The insurance company, in making a Life Only, No Refund annuity payment guarantee, incurs no cost for guaranteeing a survivor benefit or, in the jargon of the insurance industry, a refund feature. It is the cost of these refund features which necessitates that annuity payments calculated using such a benefit be lower than the amount of a Life Only, No Refund annuity.  A second payout type is **Life Annuity, With Refund**. As with all life payout options, the main guarantee is that payments will continue for the annuitant’s lifetime. But should the annuitant die during the refund period, the insurance company must pay the refund amount to the designated beneficiary.  Refund arrangements come in various flavors. The **Period Certain** refund type says that if the annuitant dies before the end of a certain period of time, payments will continue to the beneficiary for the remainder of that period. For example, the most common payout arrangement is **Life and 10-Year Certain**. This arrangement provides for payments that are guaranteed to continue for the annuitant’s life, however long. If that annuitant should not live to receive 10 years’ payments—if payments are monthly, that is 120 monthly payments—the remaining paymentswill continue to the beneficiary named in the policy until the 10-year term is complete.  The **Cash Refund** or **Installment Refund** payout option says that if the annuitant dies before receiving a specified amount—which may or may not be less than the amount originally annuitized—the balance will be paid to the beneficiary, either in a lump sum or in installments.  Not all annuities are payable for life***.*** A third payout type, the so-called **Period Certain** option, pays an income for a certain period***.*** A 20-year period certain payout option will pay for exactly 20 years and no more or fewer. If the annuitant dies during that period, payments continue to the beneficiary (or to a contingent annuitant if one is named). If the annuitant is still living at the end of 20 years, payments cease.  The terminology almost begs formisunderstanding. Life and 10-Year Certain sounds a lot like 10-Year Certain. But they are very different payout options. The first one will pay for the longerof 10 years or the annuitant’s lifetime. The second will pay, in any and all events, for exactly and only 10 years. No more, no less. Many prospective annuity buyers will miss this distinction. No matter how careful the advisor is in explaining how that arrangement works, some people hear just the 10 Years part and focus on it. Many years ago, in talking with an elderly prospective client, one of the authors thoughthe had explained the Life and 10 Year Certain annuity he was recommending adequately. But, after he had finished, she expressed concern. “I like having that amount every month,” she said, “and I especially like knowing that amount won’t change, but I’m a bit worried. You see, I may live longerthan 10 years, and then what?”  One way of avoiding this confusion, when structuring lifeannuities, is to consider using either Cash Refundor Installment Refund arrangements to address the risk of the annuitant’s dying prematurely. It is far more easily explained and understood, and does not let the duration of the certain element distract attention from the lifetimeguarantee, which is, the main purpose of the arrangement.  The fourth type of payout includes arrangements that cover more than one annuitant. The most common type is that of the various **Joint and Survivor**payout options and normally allows only two annuitants. These are lifeannuity payouts—they persist until bothannuitants have died. The amount of the annuity payment may remain unchanged at the first death (this is called Joint and 100% Survivor) or may be reduced by some percentage or fraction. For example, Joint and ⅔ means that the surviving annuitant will receive, commencing at the death of the first annuitant, an income equal to ⅔ of the original annuity amount. Some contracts allow Joint and Survivor payouts with a refund feature. | | |