Basics of Annuities

# What is an Annuity?

The term annuity simply means a series of regular payments over time. In popular usage, however, annuity generally refers to a contract or 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 (see the section entitled “Parties to the Annuity Contract”). These contracts, called commercial annuities, are what we will be talking about throughout
this book.

# Types of Annuities

There are different types of annuities, which are generally classified according to three different parameters:

1. how the annuity is purchased;

2. when annuity payments are to begin; and

3. how the cash value in the annuity is invested.

# How the Annuity is Purchased

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. While deferred annuities may be purchased on either a single premium or a flexible premium basis, immediate annuities are always purchased with a single premium.

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.

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# When Annuity Payments Are to Begin

An immediate annuity is one in which regular income—or annuity—payments begin to be made to the owner[[1]](#endnote-1) 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, during which the annuity contract may grow in value for the crediting of interest (in the case of a fixed annuity) or the change in value of the subaccounts (with a variable annuity). 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 eighty-five, or annuitant’s age eighty-five). 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]](#endnote-2)

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 (see the section entitled “Types of Annuity Payouts”).

Note: It is essential that the advisor understand the difference between an annuity contract’s required annuity starting date (i.e., the date by which annuity payments must commence, absent an election to defer annuitization) and when annuitization is permitted under 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, if that is his/her wish.

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There is no accumulation phase in the life of an immediate annuity, 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 until a future date, which may be for many years after purchase. Currently, there are two types of longevity annuities: (a) “pure longevity annuities,” which provide no death benefit if the buyer does not live to the annuity starting age and often specify a set starting age and (b) “Deferred Income Annuities,” which often provide both a death benefit and a choice as to annuity starting ages. See Chapter 8 for a detailed discussion of longevity annuities.

# 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 units or annuity units, depending upon whether the contract is in the accumulation phase or 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[[3]](#endnote-3) chosen by the contract owner. We will look at how accumulation units and annuity units work shortly. First, however, let’s understand the basic investment difference between fixed and variable annuities.

Fixed Annuities

A fixed annuity may be either immediate or deferred.

Fixed Immediate Annuities

All single premium immediate annuities (fixed or variable) provide an income (annual, semiannual, quarterly, or monthly), either for a specified period or for life. These payout options are described later in this chapter.

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Fixed Deferred Annuities

In a fixed deferred annuity, the 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 deferred annuities provide guarantees as to the period during which the current interest rate will be credited, and all deferred annuities provide a guaranteed minimum interest 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 immediate annuity, or a fixed deferred annuity 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 deferred annuity, 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 fixed deferred 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 value is the value to which an annuity payout factor will 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 value of a deferred annuity is the cash value, less any applicable surrender charge and market value adjustment (see Chapter 5: Basic Costs of Annuities) 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 deferred annuity, the cash value, which includes all premium payments and prior interest credited, is

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guaranteed against loss, as is a minimum interest 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. By contrast, the contract owner of a variable annuity retains an investment risk. (See further discussion below regarding variable annuities.) In a variable immediate annuity, the amount of each year’s annuity payment will vary with the performance of the investment accounts chosen. In a deferred variable annuity, 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

A variable annuity may be either immediate or deferred.

Variable Immediate Annuities

Like fixed immediate annuities, variable immediate annuities provide regular annuity payments, commencing within one year of purchase. The annuity payout options are typically the same as with immediate fixed annuities. The chief difference is that the annual income in a variable annuity will vary with the performance of the investment accounts chosen. A second difference is that, unlike fixed immediate annuities, variable immediate annuities typically impose an asset management charge that is taken into account by the insurer in declaring the current year’s annuity payment.

Variable deferred annuities work very differently from fixed annuities, in both the accumulation phase and in the distribution phase.

Variable Deferred Annuities

The Accumulation Phase

In the accumulation phase of a variable deferred annuity,[[4]](#endnote-4) each premium payment purchases, after applicable contract charges are deducted, a number of accumulation units for each investment subaccount chosen by the contract holder. The cash value will vary with the performance of those investment subaccounts; there is no guarantee either of principal or of minimum interest, except for cash values placed in the so-called “fixed account.”

Example: Mr. Jones has chosen five investment subaccounts from among those available in his variable deferred annuity. He has directed that each premium payment[[5]](#endnote-5) be allocated to these accounts as follows:

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* Large Cap Growth Account A: 20%
* Midcap Value Account M: 20%
* Small Cap Value Account S: 20%
* International Stock Acct I: 15%
* Bond Account B: 25%

The accumulation unit values of these accounts on the day his premium is received are as follows:

* Large Cap Growth Account A: $21,435
* Midcap Value Account M: $16,567
* Small Cap Value Account S: $34,123
* International Stock Acct I $9,567
* Bond Account B $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 A: 9.1999 units
* Midcap Value Account M: 11.9032 units
* Small Cap Value Account S: 5.7791 units
* International Stock Acct I: 15.4594 units
* Bond Account B: 16.4300 units[[6]](#endnote-6)

Accumulation unit values can, and often will, change each day according to the investment performance of the subaccounts, just as the net asset value of a mutual fund share does. However, there is a significant difference between the pricing of annuity accumulation units and 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 reinvest such distributions, additional shares are purchased for his account, and the price of all shares of the fund is reduced to reflect the distribution. If the

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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 unit is increased reflecting the dividend or gain received, but the number of units remains the same.

Investment Sub-Accounts

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 proprietary accounts; 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,*[[7]](#endnote-7)* managed by a variety of money management firms. Typically, the contract owner is permitted to choose several subaccounts,[[8]](#endnote-8) and to make exchanges among them—re-allocating existing contract values—and to reallocate ongoing contributions without charge.[[9]](#endnote-9) 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[[10]](#endnote-10) to the variable subaccounts, make the modern variable annuity a robust and powerful investment management tool.

Notably, the cash values in the investment accounts chosen by the buyer of a variable deferred annuity are not invested directly in the issuing insurance company’s general account (and therefore are not subject to the credit risk of the insurer), but are held separately (which is why they are often called “investment accounts”). On the other hand, funds that are invested in the general account (often also known as the “fixed account”) of a variable annuity are invested directly with the insurer, receiving the interest rate and potential income/growth guarantees of the fixed account, but also subject to the general credit risk of the insurer.

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 a Life and Ten Year Certain payout arrangement, and if the annual annuity payout factor for that option, for his age and sex, is 5.67, his annuity payments will be $5,670 per year

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from that point until the later of his death or the expiration of ten years. Similarly, if he elects to annuitize a variable deferred annuity on a fixed annuity payout arrangement, and if the total value of the accumulation units in 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 in a variable annuity is to be on a variable basis, 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 units the owner wishes to annuitize[[11]](#endnote-11)) 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.[[12]](#endnote-12) The process works as follows:

* First, the payment, or annuitization amount, is reduced by any contract fee applicable and by any state premium tax due, and allocated to the investment subaccounts chosen by the contract owner.
* Next, the insurance company computes an initial income payment amount for that portion of the purchase payment or annuitization amount allocated to each subaccount, using (a) the age and sex[[13]](#endnote-13) of the annuitant and (b) an assumed investment rate (AIR). Many variable annuity contracts allow the purchaser to choose among several AIRs (e.g., three percent, four percent, five percent, and six percent). The higher the initial AIR chosen, the higher the initial variable income payment will be.
* Finally, the initial income payment is divided by the value of the annuity unit for each subaccount chosen. The result is the number of annuity units of 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 subaccounts exceeds or lags the AIR.

Parties to the Annuity Contract

There are four parties to a commercial annuity contract.

1. The annuity company is the party that issues the policy, and is obligated to keep all the promises made in it.

2. The annuitant is the individual—and it must be an individual, a human being—who may or may not also be the owner of the policy. The age and sex of the annuitant

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 determine—for life annuities—the amount of each annuity payment. The annuitant is merely the measuring life for purposes of annuity payment calculations. He or she has NO rights in the annuity contract as annuitant.

3. The beneficiary is the party who will receive any death benefit payable under the annuity, whether as a lump sum or a continuation of annuity payments. However, not all annuities will have a beneficiary because if payments cease at the annuitant’s death, there is nothing for a beneficiary to receive. In most cases, the beneficiary has no other rights, except if the beneficiary is named irrevocably.

4. The owner is the individual or entity—it need not be a human—that has all ownership rights in the contract, including the right to name the annuitant and beneficiary, to elect commencement of annuity payments, and to surrender the contract. Occasionally, advisors will suggest that a nonqualified annuity[[14]](#endnote-14) be owned jointly; usually when the owners are a married couple. As will be discussed in Chapter 3, this arrangement can produce unexpected problems and should be avoided unless the client and advisors are aware of the implications of such ownership.

# 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 that 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.

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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 Ten-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 ten years’ payments—if payments are monthly, that is 120 monthly payments—the remaining payments will continue to the beneficiary named in the policy until the ten-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 twenty-year period certain payout option will pay for exactly twenty 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 twenty years, payments cease.

The terminology almost begs for misunderstanding. Life and 10-Year Certain sounds a lot like Ten-Year Certain. But they are very different payout options. The first one will pay for the longer of ten years or the annuitant’s lifetime. The second will pay, in any and all events, for exactly and only ten 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 Ten Years part and focus on it. Many years ago, in talking with an elderly prospective client, one of the authors thought he had explained the Life and Ten 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 longer than ten years, and then what?”

One way of avoiding this confusion, when structuring life annuities, is to consider using either Cash Refund or 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 lifetime guarantee, which is, the main purpose of the arrangement.

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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 life annuity payouts—they persist until both annuitants have died. The amount of the annuity payment may remain unchanged at the first death (this is called Joint and 100 percent Survivor) or may be reduced by some percentage or fraction. For example, Joint and two-thirds means that the surviving annuitant will receive, commencing at the death of the first annuitant, an income equal to two-thirds of the original annuity amount. Some contracts allow Joint and Survivor payouts with a refund feature. A much less common option than the Joint and Survivor arrangement is called Joint Life. It, too, covers two annuitants, but pays a benefit only until the first annuitant dies.

Now that we have the basics and terminology of annuities out of the way—and the authors thank you, dear reader, for your patience—let’s get to what annuities are used for.

# The Annuity as a Tool

Annuities are tools. They are acquired because the purchaser has a particular job to be done and is willing to exchange his money for a tool to do that job. In many ways, this exchange transaction is like the purchase of a hammer. The hammer has certain specifications—type and strength of the metal, length of the handle, size of the hammer head—and when purchased from a quality company, often comes with a guarantee that the product will perform as specified.

The important key to understand about this metaphor is that we generally do not buy a hammer simply because it happens to be cheaper, or lighter, or shinier than any other hand tool in the hardware store. We purchase it because we have a need, for example, to pound a nail into a piece of wood, or anticipate having a need in the future that we want to be prepared for, and we believe that a hammer is the best tool to fulfill that need.

In addition, there are many different situations where we might need a hammer, and each of those situations may call for a different one. Clearly, using a sledgehammer to drive a small nail into your drywall to hang a picture is the wrong tool for the job. Thus, the key in purchasing the right hammer is understanding the need and the job you’re hoping to accomplish with it. Only once you understand the right situation for any particular hammer can you determine whether a hammer is the right tool for the job, and which type you need.

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To complete the analogy, the key to decision-making when it comes to annuities is first to understand the problems for which the annuity can represent a solution. Only then can one actually determine whether an annuity is the right tool to solve the problem, and which sort of annuity will best accomplish the task.

# Overview: The Annuity as a Problem-Solving Tool

We are all familiar with the kinds of problems that hammers solve, such as driving a small nail, pounding a large nail, or forcing a wedge between two pieces of wood to separate them. The problems that the annuity-as-a-tool are meant to solve are quite varied because of the broad number and types of annuity-tools available. That said, the problems that annuities solve—the needs that they meet—can be identified and separated into several general categories:

1. The need for a known income stream. This is what annuities do best, because annuities—whether deferred or immediate—are really designed to generate income. The known part may be the amount of the income stream, the duration, or both. The amount might be fixed or determined by a formula. The duration might be for a specified period, for the lifetime of the annuitant, or the longer of the two. The amount of each annuity payment may be greater than one could obtain, with absolute certainty, from other savings or investment vehicles. However, it must be noted that annuity income (meaning regular annuity payments, not partial withdrawals) are part principal. An annuitant is not living on her income, but on income and principal.

2. The need for a guaranteed rate of return. As we’ve noted, the current interest crediting rate in most deferred annuities may potentially be changed every quarter, year, or at the discretion of the insurance company. A notable exception is the so-called CD annuity—a fixed deferred annuity with multi-year current rate guarantees. Often, the rate guarantee extends to the end of the surrender charge period, which is usually six years or less. Depending upon contractual provisions, especially the surrender charge schedule, and whether interest rates are rising or falling, longer rate guarantee periods may offer lower or higher rates than shorter periods. In any event, the rate of return is contractually guaranteed.

3. The need for a better nonguaranteed rate of return. Although their current crediting rate is usually not guaranteed beyond an initial period, deferred annuities have, historically, paid somewhat higher current returns as a class, than some other fixed-dollar investments, such as passbook savings and certificates of deposit.

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4. The need or desire for tax advantages. One of the main appeals of a deferred annuity is tax-deferred growth. Although the gain will ultimately be taxed (tax-deferred does not mean tax-free), tax deferral maximizes the benefit of compounding. Moreover, annual growth not distributed is not recognized as income for any tax purpose, including the taxability of Social Security benefits. Immediate annuities, too, receive favorable income tax treatment. A portion of each annuity payment is considered return of principal and is not taxable.

5. A guaranteed payment in the event of death. Although annuities are not life insurance policies, and are not taxed as such, they can provide guaranteed death benefits. A fixed deferred annuity offers a guarantee of principal (and previously credited interest), and most such contracts waive surrender charges upon death. Variable deferred annuities typically offer a guaranteed minimum death benefit. Immediate annuities, while designed to amortize both principal and earnings over the annuity payout period, may be structured with a refund feature to guarantee a minimum payout, whether to the living annuitant or her beneficiary (if the annuitant should die early). That said, annuities are designed primarily to provide living benefits. If a guaranteed death benefit is a client’s main concern, life insurance is often a better tool (provided the client is insurable). Just as a hammer can be used to pry apart two-by-fours, a pry bar is probably a better choice (so long as the job does not involve driving nails).

# Is an Annuity the Right Tool, and, If So, Which Kind Will Do the Best Job?

Now that we’ve defined some of the needs that annuities can solve, we will begin to focus on how to match particular kinds of annuities to manage the risks inherent in those needs, and understand the annuity as a risk management tool.

When the Client Needs a Known Income Stream

For the client who requires a certain income stream commencing within one year, an immediate annuity is an almost intuitive choice. Providing income—certain as to amount, duration, or both—is what an immediate annuity does. But first we need to ask a key question: For how long will the income stream be required?

If the need is for an income for life, an immediate life annuity makes good sense. It is the only financial instrument that can guarantee a specific amount of income for as long as the recipient lives. It allows the purchaser to manage the risk that the asset base that is used to create the payments may not earn an adequate rate of return, or may not be large enough to provide enough payments for life (i.e., the risk of outliving one’s assets). Some immediate

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annuities can be structured so that annuity payments will increase each year by a specified percentage. This is sometimes known as the COLA (cost-of-living-adjustment) option. Unfortunately, many insurance companies do not offer such an option in their immediate annuity portfolios.

Similarly, if the need is for an income specified for a period of years, an immediate period certain annuity may be an appropriate choice. It, too, manages the risk of an unknown future rate of return over the time period, and the risk that the asset base, or the dollars used to create the income stream, may not be sufficient to produce the income required.

One risk often cited by critics of immediate annuities is that the buyer has locked in current interest rates. This criticism is generally voiced during periods when prevailing interest rates are unusually low. How valid is this criticism? In the authors’ opinion, it has merit, from an investment perspective. The interest rate used in the calculation of the annuity payout factor—the number of dollars, per thousand dollars of purchase payment that the annuitant will receive each period—is, indeed, locked in. Should prevailing interest rates rise over the period of time during which annuity payments are made, those annuity payments will not reflect that rise. However, the authors feel that from a risk management perspective, this criticism is misdirected. If the goal is to ensure an income level, the relevant risk is whether the dollars invested to produce that income can do so with certainty. A rise in prevailing rates would not present that risk, but a decline would. To transfer that risk from the annuity buyer to the insurance company, the buyer must incur a cost. Locking in the annuity interest rate is part of that cost.

It should be noted, though, that the changes in interest rates used in immediate annuity calculations over the past two decades have been far less dramatic than the changes in interest rates for short-term instruments such as savings accounts and certificates of deposit. While it is true that the purchaser of an immediate annuity in June, 2014 is locking in an interest rate lower than would have been used for someone the same age and sex in, say, June, 2004, the difference is not as great as one might think. By the same token, if interest rates should trend sharply upward in the next ten years, the locked in rates ten years hence will probably not be substantially greater than the current ones.

When the Client Needs a Guaranteed Rate of Return

When a specific minimum return on investment and preservation of principal is required to accomplish a particular goal, an immediate annuity makes no sense because it does not preserve principal. The income payments from an immediate annuity, while they

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may be larger than might be achievable from alternatives, are not just a return on investment, but a combination of return on and return of investment. However, a deferred annuity offering a multi-year interest rate guarantee may well provide a solution. The risk of getting an inadequate rate of return is managed by transferring it to the insurance company issuing the annuity. This provides a total or minimum rate of return guaranteed to equal or exceed the return required. However, it is important to note that there is a lack of liquidity cost associated with these annuities. This is because the insurance company makes its guarantees assuming it will have use of the money used to purchase the annuity. Typically, a deferred annuity contract does not become profitable for an insurer until after it has been in force for several years due to commissions, other issuing charges, administrative costs, deferred acquisition costs, taxes, and reserve requirements. If the annuity owner elects to surrender or take withdrawals from the annuity in the early contract years, he will usually be required to pay a surrender charge. The amount and terms of this vary considerably from contract to contract.

Recently, many variable deferred annuities have been marketed with guaranteed living benefits. The structure and provisions of these policies vary greatly, but it should be noted that the guarantees provided may not be equivalent to the guaranteed minimum rate of return of fixed annuities, and usually require annuitization, minimum holding periods, or other conditions for the guarantees to be effective. For an extensive discussion of the various living benefits available with variable annuities, see Chapter 5.

When the Client Needs a Better Non-Guaranteed Rate of Return

With the exception of fixed annuities with multi-year current rate guarantees, or so-called CD annuities, no deferred annuity guarantees the current rate of return for more than a year at most. Although, all fixed annuities offer a guaranteed minimum rate of return. Variable deferred annuities generally do not offer any guarantees of return or of principal, except where the fixed investment account is used or as provided by optional riders. That said, we should bear in mind that most other long-term investments do not offer such guarantees either. For clients who require a guarantee of principal and are willing to accept a current rate that may change, deferred fixed annuities may offer better returns than certificates of deposit or individual bonds. The interest rate history of many fixed annuities has exceeded that of CDs, although there can be no assurance that this will hold true in the future.

When comparing the interest crediting rate of a deferred annuity with that of an alternative, the diligent advisor will point out not only any applicable surrender charges, but also the early distribution penalty that applies to withdrawals taken prior to age fifty-

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nine and a half, unless an exception is available. Those are essential elements in any sound risk management decision. So, too, is the fact that earnings in deferred annuities are not taxed until distributed.

When the Client Wants and Needs Income Tax Deferral

Tax deferral is perhaps the most advertised and promoted advantage of deferred annuities. Earnings are not taxed until distributed, either to living contract owners or beneficiaries. The advantages of such deferral are well recognized. However, the cost of such tax deferral, granted by Section 72 of the Internal Revenue Code, is a requirement in the same section that all distributions from annuities be taxed at ordinary income rates. No capital gains treatment is ever available under current law. Whether this trade-off is favorable, or appropriate, is a matter of considerable controversy. In the authors’ view, it is always a matter of individual facts and circumstances, for reasons that will be discussed in later chapters.

When the Client Needs a Guaranteed Payment in the Event of Death

An often-overlooked feature of deferred annuities is the right of the beneficiary to receive a guaranteed payment, or a payment determined by a guaranteed formula, in the event of death. This payment may not occur until the distant future, but upon purchase of the contract the owner knows exactly what the minimum payment will be or how it will be determined.

When is this important? When the client requires that a certain amount be available upon death, regardless of investment performance in the meantime. This guarantee allows a variable deferred annuity owner to manage the risk that inadequate investment performance will cause a smaller amount to pass to her beneficiaries than desired, regardless of actual investment performance over the time period until death. The authors strongly believe, however, that, when the need for such guaranteed death benefit is a primary concern, life insurance generally represents a far more efficient solution, if available.

Summary: The Annuity as a Tool

The guarantees that the annuity-tool provides allow clients and their advisors to solve certain problems and to meet certain needs. Specifically, it allows us to meet those needs despite risks that might cause us to fail. Thus, at its most fundamental level, annuities serve as tools that allow us to manage risks—specifically, the risks that:

* distributions from an investment will be inadequate to meet specified goals;

Basics of Annuities

* earnings on an investment will be inadequate to meet specified goals; and the amount available to heirs, from the investment, will be inadequate to meet specified goals.

Our discussion of annuities, and potential applications for them, throughout the remainder of this book will proceed with the understanding that annuities are nothing more than risk management tools that allow us to accomplish certain needs and goals with certainty—or at least increased likelihood—because of the underlying guarantees that they hold.

Determining When a Risk Management Tool (Annuity) is Appropriate

In all cases, the annuity tool solution will have a cost associated with it—the cost of the annuity and the guarantees that it provides. Because of these costs, the solution provided often will not be the solution with the highest expected value or projected return on investment. However, the decision to accept a lower fully guaranteed value in exchange for a higher, but unguaranteed, expected value is a risk-return tradeoff that can, and should, be examined and made on a case-by-case basis. In many instances, when presented with both options, the client will choose the option most likely to succeed, not the one with the highest expected return.

It is also important to remember that, in the search to maximize the probability of success, it is entirely possible that the client will not actually need to utilize the guarantees provided by an annuity. Annuities manage risks of loss; there is no guarantee that such losses will occur in the first place. Annuities offer purchasers options to utilize certain guarantees; they do not require the exercise of those options. Thus, it may be that a guarantee within a client’s annuity is never actually put to use. Nonetheless, owning the annuity may very well have still been the right choice. That the guarantees may never be put to use does not mean the cost of those guarantees was a waste. Your house may never burn down, but it is still prudent to maintain your homeowner’s insurance and pay premiums for years. Doing so buys you a guarantee that you will not lose the entire value of your house, and may produce ancillary benefits such as allowing you to obtain a mortgage. In any event, it can provide you with invaluable peace of mind, and the ability to enjoy your life knowing that a particular risk had been transferred—insured—away.

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1. Some insurance companies will issue annuity checks to a nonowner annuitant if requested to do so by the owner. [↑](#endnote-ref-1)
2. Such deferral may require the insurance company’s approval. [↑](#endnote-ref-2)
3. These are also referred to as investment subaccounts. [↑](#endnote-ref-3)
4. As we have noted, there is no accumulation phase in a variable immediate annuity. [↑](#endnote-ref-4)
5. After deduction for contract charges. [↑](#endnote-ref-5)
6. We have illustrated four decimal places precision for units purchased and three decimal places for unit values in this example. Some insurers use greater precision and some use less. [↑](#endnote-ref-6)
7. Asset classes are investment types having distinct risk/return characteristics, such as U.S. Large Cap Growth Stocks, Foreign Stocks, U.S. Real Estate, U.S. Long Term Gov’t Bonds, etc. [↑](#endnote-ref-7)
8. Some contracts require a minimum initial and/or ongoing contribution per subaccount. [↑](#endnote-ref-8)
9. Most contracts impose a maximum on the number of exchanges permitted per month and may levy a charge for additional excess exchanges. These restrictions are generally in place to prevent active trading using the investment subaccounts, but are not intended to restrict normal occasional trading and re-balancing. [↑](#endnote-ref-9)
10. The fixed account in a deferred variable annuity typically guarantees a minimum interest rate and may offer a guaranteed duration for the current declared interest rate. In addition, the principal—including all prior credited interest—is typically guaranteed against loss. [↑](#endnote-ref-10)
11. Some variable deferred annuities permit partial annuitization. Others require that the entire value of the contractholder’s accumulation units be annuitized. [↑](#endnote-ref-11)
12. Some variable annuity literature describes this process as a conversion of the existing accumulation units to annuity units. [↑](#endnote-ref-12)
13. If the annuity uses unisex annuity factors, the sex of the annuitant is not considered. Most commercial annuities use sex-distinct factors. Unisex factors are most often seen in contracts used to fund qualified retirement plans, where sex-distinct factors in such an employment context are considered to impose potentially unlawful discrimination. [↑](#endnote-ref-13)
14. An annuity purchased with after-tax dollars that will not fund an IRA or tax-qualified plan. [↑](#endnote-ref-14)