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Annuities are insurance company products that are designed to pay periodic benefits during the lifetime of the annuity holder. Because they are considered a form of insurance product, annuities are accorded the advantage of tax-deferred compounding of income generated in the annuity account. There are several types of annuities, with variations based upon the pay-in period and based upon the methods of determining the benefits paid out. The common elements are that the purchaser pays in money (premiums) to the insurance company, the insurance company invests the money, and eventually begins paying a stream of periodic benefits (which sometimes continue after the death of the annuitant or may terminate with a lump sum payment upon death).

# Immediate and Deferred Annuities

There are two basic annuity types: immediate annuities and deferred annuities. An immediate annuity is purchased with a one-time up-front payment, and the periodic benefit stream begins immediately. These are typically purchased by retirees, who may have a pool of money available from a retirement plan and want to assure a guaranteed periodic income flow during retirement.

By contrast, a deferred annuity involves the postponement of the commencement of periodic benefits until some future date, typically corresponding with the purchaser's expected retirement. A deferred annuity may be purchased with a single lump sum premium (referred to as a single-premium deferred annuity (SPDA)), with benefits deferred, or as is most commonly the case, premiums are paid in periodic or irregular installments (referred to as a flexible-premium deferred annuity). Deferred annuities are usually purchased for future retirement income by younger workers making periodic payments during their working years.

# Fixed Annuities and Variable Annuities

In the case of a fixed annuity, the insurance company fixes the rate, for a specified period, at which income will accrue to the account. The fixed rate is determined by the company based upon its projection of current investment market conditions. (Any variance between the fixed rate and what the insurance company actually earns for the year is absorbed by the company.) Most contracts include a guaranteed minimum rate, below which the fixed annual return may not go.

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By contrast, a variable annuity places the risks and rewards of investment performance upon the annuity holder. The annuity holder determines how his or her account funds are to be invested, by selecting among a group of portfolio types offered by the insurance company (so-called "separate accounts"). Choices may include money market funds, stocks, bonds, and may be further refined by such factors as growth, value, income, international, etc. The ultimate value of the holder's account, and the size and/or duration of future periodic annuity benefits will be dependent upon the relative performance of the holder's investment choices. This in turn will be affected by the relative success of the specific investments within the separate accounts selected by the annuity holder. Thus, the purchaser of a variable annuity contract would be well advised to investigate the investment performance history of the separate accounts, in much the same way that performance history would be evaluated before investing in a mutual fund.

# Equity Indexed Annuities

An equity 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. Sales of equity indexed annuities (EIAs) have grown considerably in recent years. One of the most important features of an EIA is the method used to calculate the gain in the index to which the annuity is linked.

EIAs have characteristics of both fixed and variable annuities. Their return varies more than a fixed annuity, but not as much as a variable annuity. Thus EIAs contain more risk (but have more potential for a greater return) than a fixed annuity. EIAs also 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 and have the potential to earn higher returns than traditional fixed annuities in a rising stock market. For example, many single premium deferred annuity contracts guarantee the minimum value will never be less than 90 percent of the premium paid, plus at least 3 percent in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, annuitizations and death benefits.

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## 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. Many EIAs are based on the S&P 500, but other indexes are also used.

## How is an EIA's index-linked interest rate computed?

The index-linked gain depends on the particular combination of indexing features that a particular EIA uses. The most common indexing features are listed below.

***Participation Rates:*** The participation rate decides how much of the increase in the index will be used to calculate index-linked interest. For example, if the calculated change in the index is 9 percent and the participation rate is 70 percent, the index-linked interest rate is 6.3 percent (9% x 70% = 6.3%). A company may set a different participation rate for newly issued annuities daily. The initial participation rate is typically guaranteed for a specific period. Some EIAs guarantee that the participation rate will never be set lower than a specified minimum or higher than a specified maximum.

***Spread/Margin/Administrative Fee:*** Some EIAs use a spread, margin or administrative 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 total 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. (Note that EIAs that have caps may have a higher a participation rate.)

Some EIA contracts allow the insurance company to change participation rates, cap rates, or spread/margin/administrative fees annually or at the start of the next contract term.

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## Surrender Charges

The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA. Also, some EIAs will not credit index-linked interest in the event of an early surrender. Also, any withdrawals from tax-deferred annuities prior to age 59½ are generally subject to a 10 percent tax penalty in addition to any gain being taxed as ordinary income.

## 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: Since the interest earned is locked in annually and the index value is reset at the end of each year, future decreases in the index will not affect the interest already earned. Thus, the annual reset method may credit more interest than annuities using other methods when the index fluctuates up and down often during the term.Disadvantage: Often combined with other features, such as lower cap rates and participation rates that will limit the amount of interest 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: Since interest is calculated using the highest value of the index on a contract anniversary during the term, this design may credit higher interest than other designs if the index reaches a high point early or in the middle of the term, then drops off at the end of the term.Disadvantage: Because interest is not credited until the end of the term, index-linked gain will be lost if EIA is surrendered early. It can also be combined with other features; such as lower cap rates and participation rates that will limit the amount of interest 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: Since interest cannot be calculated before the end of the term, use of this design may permit a higher participation rate than annuities using other designs.Disadvantage: Relies on single point in time to calculate interest. If index declines dramatically on the last day of the term, then part or all of the earlier gain can be lost.  |

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***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 credited.

***Interest Calculation:*** Some EIAs pay simple interest during the term of the annuity versus compounding of interest.

***Exclusion of Dividends:*** Depending on the index used, stock dividends may or may not be included in the index's value. For example, the S&P 500 is a stock price index and only considers the prices of stocks. It does not recognize any dividends paid on those stocks.

Annuity Income Payments and Death Benefit

One of the most important benefits of deferred annuities is the right to use the accumulated value to provide income payments during the payout period. The size of income payments is based on both the accumulated value and the annuity's benefit rate that is in effect when income payments begin.

The benefits rate determines the amount of income payment made for each $1,000 of accumulated value. The benefit rate depends on age and sex, and the form of annuity payment chosen (for example, lifetime, joint and survivor, or payments that continue for a set number of years).

The most common death benefit is either the guaranteed minimum value or the value determined by the index-linked formula.

## EIA questions that arise at the point of sale:

* What is the guaranteed minimum interest rate?
* What charges, if any, are deducted from my premium?
* What charges, if any, are deducted from my contract value?
* How long is the term?
* What is the participation rate?
* For how long is the participation rate guaranteed?
* Is there a minimum participation rate?
* Does my contract have a cap?

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* Is averaging used? How does it work?
* Is interest compounded during a term? Is there a margin, spread, or administrative fee? Is that in addition to or instead of a participation rate?
* Which indexing method is used in my contract?
* What are the surrender charges or penalties if I want to end my contract early and take out all of my money?
* Can I get a partial withdrawal without paying charges or losing interest? Does my contract have vesting?
* Does my annuity waive withdrawal charges if I am confined to a nursing home or diagnosed with a terminal illness?
* What annuity income payment options do I have?
* What is the death benefit?

# Benefit Payout Variations

Once annuity payments begin (usually at retirement, or at such time as may be selected by the annuity holder), there are various options regarding the amount and duration of the periodic payments. For example, payments can be for a fixed period of years, or for the life of the annuitant, or for life with a guaranteed minimum. The longer the fixed or actuarially anticipated payout period, the lower the amount of each payment the annuitant will receive, and vice versa. This is based upon the value of the annuity account at the commencement of benefits and the anticipated additional earnings on the account during the expected payout period. The most common payout options offered are summarized below.

## Life Annuity

Periodic payments are guaranteed to continue for the life of the annuitant, and will terminate upon death. Thus, the amount of the fixed periodic benefit will be based upon the annuitant's life expectancy.

## Life Annuity with 10-Year Term Certain

This arrangement provides payments for the life of the annuitant, but with the added feature that if he or she dies before receiving benefits for at least 10 years, the benefits will continue for the full 10 years, payable to a designated beneficiary.

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## 10-Year Term Certain

This annuity provides simply for a ten-year payout period, after which the contract is ended, regardless whether or not the annuitant is still living. If he or she dies within the 10-year period, the benefits for the remainder of the period are paid to a designated beneficiary.

## Joint and Survivor Annuity

As the name implies, a joint and survivor annuity provides benefits during the lives of two individuals, usually husband and wife. When the first of the two annuitants dies, payments continue to be made to the survivor until he or she dies. Frequently, the payments are structured to be higher during the period that both annuitants are living, with a reduction in amount after the death of the first to die.

# Income Tax Treatment of Annuities

As stated above, annuities are a form of tax-favored investment because of the tax-deferred compounding of income within the annuity account. Once benefit payouts begin, income tax is imposed to the extent that the payments include such income. The basic approach involves an allocation of each annuity payment as between income and recovery of investment (i.e., premiums paid in). This can be a complicated process, and differing rules are applicable depending upon such factors as when payments commence and whether a payment is periodic installment or a lump-sum.