Tax Deferred Annuities

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Introduction

In the past three decades tax deferred annuities have emerged as a commonly used retirement planning tool by financial advisors, estate planning attorneys as well as CPAs/accountants. As the financial services industry has undergone dramatic change, depository financial institutions, brokerage firms and insurance companies have changed their product menus to appeal to a broader spectrum of the investing public, especially those at or near retirement. In particular, insurance companies have diversified their operations away from the management of mortality and morbidity risk to include investment risk. This has been prompted partially by increased competition from banks and brokerage firms but also because the general population's demand for traditional life insurance products has been replaced with a demand for "transactional" investments that offer features which make them appropriate for retirement portfolios. As the country's population has increased in age, due to medical advancement that have increased longevity and the demographic bubble known as the "baby boomers", there has been an increased focus on retirement planning.

There is a serious shortage of understanding of annuities by the people who can benefit the most from them: the investing and saving public who have retirement on their minds. Annuities offer many attributes not found in other conservative savings vehicles but there has been a general lack of emphasis on informing the public about annuities. The only real emphasis has been from knowledgeable financial advisors that are too often viewed as commission salesperson who are hawking products for the commission and have little regard for the welfare of their investing clients. This is generally not the case but anytime a commission is involved, the buying public raises their guard in fear of being "sold" something that is not in their best interest. Annuities have a secure place in conservative retirement portfolios and everyone who is serious about building a retirement nest egg, or accelerating the growth rate of their investments by using the compounding available from deferring taxes, would be well-advised to learn about the benefits offered by annuities.

What is an Annuity?

An annuity is a contract between a buyer, or contract owner (typically an individual), and the issuer (typically an insurance company) whereby the contract owner agrees to pay the issuer an initial premium or payment in a lump sum, or payments over a period of time, during which the issuer guarantees the owner a stated minimum rate of return or the opportunity to participate in the growth of an underlying group of assets in which the annuity premiums are invested. As with all contracts there are numerous terms and conditions that influence the features and benefits that accrue to the owner.

Insurance companies are "rated" by the various rating agencies for claims paying ability as well as general solvency. The best known of the rating agencies of insurance companies is A.M. Best and Company, which has been rating insurance companies since 1899. Their ratings for claims paying ability range from a high A++ to a low of F. Generally, a company rated B++ to A++ is thought of as "financially sound" with little if any risk to the policyholders. Once the rating drops below this range there is need to investigate further the ratings of the other agencies (Standard and Poor's [S&P], Moody's, and Fitch).

The annuity contract is generally called a "Policy" since it is issued by an insurance company and the owner is generally referred to as the "Policyholder". This terminology is in general use even though the annuity is technically not an "insurance policy" in the traditional sense; however, it may have some of the attributes of a life insurance policy, e.g., a death benefit. There are three general classifications of annuities: fixed annuity, variable annuity and immediate annuity. These will be discussed below.

There are generally three parties to an annuity: owner, annuitant, and beneficiary. The **owner** is the individual, or individuals, who own the cash benefits of the annuity. The owner is typically the only party that can redeem the annuity for its cash value, change beneficiaries, and make other changes allowed by the annuity contract. An annuity owner can be an individual, a trust, or a business entity.

The **annuitant** is generally the individual on whose life the death benefit is contingent. The annuitant may be, and oftentimes is, the same as the owner, but such is not required. Generally, the death of the annuitant triggers the payment of the death benefit of the annuity; however, there are exceptions. Accordingly, care should be taken in naming the owner and annuitant to avoid the owner losing control of the annuity proceeds upon the death of the annuitant.

The **beneficiary** is the individual or entity that is named to receive the death benefit of the annuity. Beneficiaries may be multiple and the owner can generally add and delete a beneficiary by notifying the issuing insurance company of the change. If an annuity has a named beneficiary when the death benefit is triggered, the annuity will generally not be subjected to the probate process. Since the issuer must pay the cash proceeds of the annuity upon the death of the owner, or annuitant, age limits on both the owner and/or annuitant are imposed.

The period of time that the annuity is growing in value, which may be accompanied by additional premium payments into the annuity, is referred to as the **accumulation period**. The accumulation period may be indefinite, but in most cases there is a set limit, generally determined by the age of the owner or annuitant, or a set period following the initial premium payment. Once the end of the accumulation period is reached, the pay out period, or phase, of the annuity begins. During the pay out period the owner will receive a series of payments, or a lump sum, that is selected from a menu of options. Once the schedule of payments is completed, or death of the last named recipient if a “life only” payout is selected, the annuity ends and the contract, or policy, is terminated. A single premium immediate annuity (“SPIA”, pronounced spee-uh) does not have an accumulation period and will be discussed below.

What are the common characteristics of all annuities?

All tax qualified annuities, regardless of classification, offer income tax deferral of earnings until the earning are withdrawn. This tax deferral feature of annuities has given rise to the saying that annuities enjoy “triple compounding”: interest on the principal, interest on the interest left in the annuity, and interest on the money that ordinarily would have been withdrawn to pay taxes. The only exception to this tax deferral exception is an annuity that is owned by an entity that is not an individual or in trust for an individual. Such entities are allowed to own annuities; however, there is no tax deferral generally available.

Withdrawals

Withdrawals from an annuity are currently subjected to taxation on a last-in, first-out basis unless they are annuitized over a finite period of time or for life. Parenthetically, some older annuities may still qualify for the first-in, first-out tax treatment. The tax deferral feature of an annuity is rooted in the original purpose of the annuity, viz., to pay an income to the owner in retirement. While annuities are now owned for reasons other than retirement or to fund a stream of future income payments, the tax-deferral feature of the annuity has endured as insurance companies have lobbied effectively to retain this benefit.

Asset protection

This same “retirement purpose” of an annuity has immunized them from creditors in many states. As the use of annuities has changed so have the attitudes of the various law-making bodies of the states and at this time there is great variability among states regarding creditors. Accordingly, the reader is advised to confirm the “creditor exempt” status of annuities in the states in which they are used. Obviously, even in states that exempt annuities from creditor claims there are always extenuating circumstances that could negate their exempt status.

1035 exchanges

One annuity may be exchanged for another annuity in accordance with the Internal Revenue Code Section 1035(e). Such 1035 exchanges do not trigger a taxable event and may be affected at any time regardless of the age of the owner or annuitant. Furthermore, the cash value of a life insurance policy may also be exchanged for an annuity without tax consequences, but the reverse is not permitted without triggering a taxable event. It should be noted, however, that many insurance companies will not honor “partial transfers” or the transfer of one annuity into multiple annuities. Nonetheless, the Revenue Service has ruled that partial exchanges may occur and that one annuity may be exchanged for two or more like annuities without taxable consequences. The exchanges in accordance with Section 1035 must occur exactly as permitted to avoid taxation; therefore, the reader is advised to consult with a knowledgeable professional when doing a tax-free exchange under Section 1035 of the IRS Code.

Investment protection

All annuities are also protected by the various State Guaranty Funds. These are reserve funds maintained by the various states to safeguard the cash value of policies, up to a certain limit, in the event an issuing insurance company is unable to meet it obligations under the contracts. A state’s guaranty fund is maintained by assessing all legal reserve insurance companies selling life insurance and annuity contracts in the state, and by having back-up access to the state’s general funds in certain situations. The amounts covered are generally at least $100,000 but some states have substantially higher limits.

Payment options

All annuities have options for payment during the pay out phase. These range from a single lump sum payment to a periodic payment over the remaining life, or joint lives, of the owner or owners. In between, the owner may choose a period certain, usually no shorter than two years and no longer than thirty years (with five and twenty being the most common range). Also, the owner may select a payment for a period certain with a life option, meaning that if he/she dies prior to the period certain (say 10 years) the payments would continue to the named beneficiary until the end of the stated period. Joint owners may select a life option that states a given payment until the first dies and thereafter the payment continued in the same amount or reduced (one-half, one-third, etc.) until the second party dies. Some annuities state that if the life option is chosen and the owner dies prior to all the paid-in premiums being paid out, the beneficiary will receive the difference between what was paid in and payment received by the owner prior to death. The payments during the pay out phase can generally be directed to one or more parties. Many annuity issuers will work with policyholders to craft a custom pay out structure for the owner. In recent years there has been an increased emphasis on pay out options, including ones that provide for an accelerated lump sum based on the present value of the expected future payments.

Death benefits

Death benefits are also a common feature of all annuities. The contract states the exact provision which varies from full market value to a stated percentage of the market value at death. Some annuities impose the surrender penalties, if still in force, at death whereas others do not. The death benefit can vary between contracts of the same insurance company; thus, the reader is advised to review each annuity's death benefit provision to ascertain the exact terms. Death benefits paid to beneficiaries of annuity contracts will be included in taxable income to the extent that they exceed the basis of the decedent in the annuity contract at the date of death. If the beneficiary elects, within one year of death, to receive a life income or installment option, then he or she will be taxed under the annuity rules.

Surrender charges

Surrender charges for early surrender are almost universal for annuities. These are sometimes called contingent deferred sales charges ("CDSC") and are imposed for a stated period of time, generally from one to twenty years depending on the annuity. Surrender charges are deducted from the cash amounts of the policy prior to being paid to the policyholder. Surrender charges are clearly stated in the contract and characteristically decline each year after the first and disappear at the end of the stated period. For example, a "typical" annuity might have ten years of surrender charges beginning at 10% in year 1 and stepping down 1% per year and completely disappearing at the end of 10th years.

If an annuity allows additional premiums after the initial premium, each addition may have its own surrender schedule or it may be subjected to the original surrender schedule with all funds in the annuity becoming surrender-free at the same time. Each contract should be inspected to determine how the surrender charges for additional premiums are handled.

Market Value Adjustment

Some annuities also employ a "Market Value Adjustment", or MVA, in addition to a schedule of surrender charges. The MVA adjusts the value of the funds in the annuity for the movement in interest rates between the period the premium was initially paid and when the withdrawal occurred. If interest rates have risen since the annuity was purchased, the issuing insurance company must replace the funds withdrawn from their portfolio with higher priced funds; thus, they impose a penalty, or negative MVA adjustment, on the policyholder by discounting the cash surrender value of the annuity. If, however, interest rates have fallen since the initial premium, the insurance company can replace the lost funds with cheaper (lower rate) funds and the policyholder is given a positive MVA adjustment or a premium above the cash surrender value of the annuity. The MVA is oftentimes a complicated mathematical formula that is provided in the policy.

Penalties

In addition to early surrender charges that are imposed by the issuer, the Internal Revenue Service ("IRS") assesses a ten percent penalty tax on earning that are withdrawn if the owner is less than 59½ at the time of the withdrawal. There are numerous exceptions to the rule, e.g., disability, if taken in substantially equal payments over the remaining life of the owner, if the payments are from a SPIA, etc. The rationale for this penalty tax is that tax-deferred annuities are long term investments that are generally ear-marked for retirement. There is one class of annuities, the tax-shelter annuity or 403(b) that generally has provisions for early withdrawal without penalty. These annuities are reserved for public employees, e.g., school teachers, or employees of non-profit organizations and are not discussed at length in this paper.

General Feature & Benefits of Annuities

The various types, or classes, of annuities have unique features and benefits that differentiate them and we will discuss these below. Annuities, regardless of type, have many features and benefits in general that distinguish them from the other investments available to the saver and investor that are accumulating, or guarding, retirement nest eggs.

Borrowing from an annuity

A few annuities have a provision that allows the owner to borrow funds from the cash surrender value. Such borrowing generally carries an interest rate that is above the earning rate being paid on the annuity and also must be repaid within a specified time period. The 403(b) type annuity generally contains a borrowing provision that is limited to certain situations, e.g., hardship, purchase of a home, etc. With the exception of the 403(b) annuity which is always funded in pre-tax dollars, borrowing from an annuity will negate its tax-deferred status. At this time there is no mandate that the issuing insurance company must report such borrowing to the IRS or withhold taxes on borrowings; thus, the owner/taxpayer must self-report such occurrences. As a general rule most issuers do not provide for loans from annuities and most policyholder should refrain from borrowing from their annuities, except in emergencies or as a funds source of last resort.

Bonus premiums

In recent years the "bonus premium" or "bonus interest rate" has been a common feature of annuities. Bonuses may be paid for the first year premiums only, the initial premium only or for all premiums for a stated number of years or time period. The size of bonuses range from as low as one percent to as high as fifteen percent, with 4% to 7% being more normal. The "bonus" is an enticement and can result in a higher "holding period" return. Even if totally recaptured in later years, the "bonus" does serve a purpose in that it (a) make the purchase more attractive, and (b) can replace penalties assessed on early withdrawal of funds used for the annuity's premium, i.e., interest lost on the early withdrawal of a bank CD, money lost on the sale of a mutual fund, or the surrender penalty from a annuity or life policy under a 1035 exchange.

The premium bonus is an addition to the amount of the premium and simply increases the size of the initial premium and earns as if it were part of the funds paid by the buyer. The interest rate bonus is an addition to the rate of interest (crediting rate) that the annuity earns on the premiums paid. There is a wide variety of conditions associated with bonuses and the reader is advised to review carefully the bonus provisions of an annuity. For example, some bonuses are lost if the owner dies prior to the end of the surrender period, or if owner takes the funds lump sum, i.e., does not annuitize for a certain time period at the end of the surrender period. If the annuity is considered a "walk away," then the client is not required to annuitize the annuity in order to keep the bonus, and if annuitization is required the annuity is generally referred to as a two-tier (discussed below).

Penalty free withdrawals

Most annuities provide for limited access to the money at the option of the owner. A typical provision is to allow ten percent of the value of the annuity to be withdrawn annually without penalty beginning in the second contract year, or a certain percent of the original premium may be withdrawn without penalty during the surrender period. Also, required minimum distributions for qualified moneys (IRA, pension or other retirement plans) are generally allowed to be withdrawn free of penalty at any time after the initial premium is paid. The general withdrawal, or liquidity, provisions of annuities vary widely and each contract should be examined to determine the exact provisions, especially if the owner is likely to need access to the money prior to the end of the surrender period.

Many annuities also have free withdrawal provisions of all or some of the annuity funds if the owner and/or annuitant are confined to a nursing home. There may be a waiting period before this provision takes effect and there may be limits on the amount and/or frequency of withdrawals. Additionally, the policy will provide the exact criteria to meet the definition of a "nursing home" or "convalescent care" provisions that trigger the free withdrawal. Another free withdrawal rider covers the diagnosis of terminal illness of the owner and/or annuitant. Again, the definition of terminal illness is contained in the contract and the amount and frequency of free withdrawals for a diagnosis of terminal illness will be stipulated. Less common in annuities is the free withdrawal of a portion of the annuity value if the owner become involuntarily unemployed. There is generally a waiting period and the amount/frequency of the withdrawals is stipulated in the contract. These riders or provisions in variable annuities are usually provided only for a fee to the owner whereas there is generally no charge if contained in a fixed annuity but may be limited to certain ages.

Spousal option

Most annuities have a spousal option which enables the spouse of the owner, or annuitant in some cases, to keep the annuity in force under the original contract upon the death of the owner or annuitant. This provision continues the tax deferral status of the earnings inside the annuity which is usually desirable if the surviving spouse is not in need of the annuity funds. Also, it prevents the loss of a bonus if the contract provisions stipulate such at early withdrawal upon death and allows the surviving spouse to avoid withdrawal penalties, or a negative MVA, if such is imposed on surrenders following death of the owner or annuitant.

Annuitization

Most annuities can be converted into a periodic income stream after a stated waiting period but prior to the end of the surrender penalty period. For example, annuitization may be allowed at any time after the first year, or later, anniversary following the initial premium provided the period over which the annuitization occur is at least the minimum stipulated in the annuity contract. Generally, the annuitization options available are the same as those discussed above and range from a period certain to life only and include all the variations previously mentioned. This feature allows a policyholder to convert their retirement nest egg into a monthly lifetime income they cannot outlive.

Taxation

The taxation of payments in annuitization or in a lump sum from non-qualified funds (those not in a qualified retirement plan such as IRA, 401(k), etc.) is determined by the “exclusion ratio”. The exclusion ratio is computed by dividing the amount of the initial premium by the sum of the payment to be received (determined by the mortality tables for life only pay out options). The exclusion ratio, which will always be less than 100%, is then multiplied by the periodic payment to determine the amount of the payment that is excluded from taxation. The amount that is not taxed, i.e., excluded, is classified as return of principal. Obviously, if the annuity being annuitized contained qualified funds, then all the income would generally be taxable if the original contributions were made in before-tax dollars. If payment is taken as a lump sum, the increase over the "basis" will generally be taxed as ordinary income.

Sales Loads

Up-front sales charges and other fees are generally not paid on fixed annuities if they are held to term, i.e., the end of the surrender penalty period. If the fixed annuity is surrendered during the penalty period, the surrender charges are sometimes called contingent deferred sales charges. Some index linked fixed and total return annuities do have provisions for the issuers to take part of the earnings as fees under certain circumstances and these will be discussed below under these classes of fixed annuities.

Variable annuities can have up-front sales charges as well on-going charges for management and other expenses associated with overseeing the portfolio of underlying assets. The sales and on-going charges of variable annuities will be carefully listed in the prospectus and should be reviewed as they can vary widely among carriers and products. Also, the financial advisor and/or client can generally choose options other than front-end fees, e.g., the advisor's commission may be a trailer fee structure (level or a percent of assets under management over the time the clients owns the annuity) or the client may be subjected to a back-end load which imposes fees when the annuity is surrendered or annuitized. In some cases, both front and back end fees are collected. Generally, the sales charges and options available are listed in the prospectus.

The fees imposed for "riders" vary widely among annuities. As a general rule fixed annuities, including index linked fixed annuities, do not impose fees for riders like free withdrawals for nursing home confinement and the diagnosis of terminal illness. Some fixed annuities assess extra fees, generally in the form of lower interest rates or participation rates, for more liberal death benefits, higher guarantees for minimum earnings and other features. Variable annuities generally assess fees for riders such as minimum guaranteed income/death/withdrawal benefits. The reader should review the annuity materials and make sure they understand the exact features of the annuities they are considering.

Aggregation rule

All annuities are subjected to the "aggregation rule". In general, this is a provision of the Internal Revenue Code which says that two or more deferred annuities (not SPIAs) purchased from the same carrier in the same calendar year will be treated for tax purposes as one annuity. If you have two annuities funded by non-qualified funds from the same carrier purchased in the same calendar year and withdraws money from only one of them, the IRS has ruled that the amount to be taxed will be determined by the earnings on both annuities. The

IRS has declared that Single Premium Immediate Annuities ("SPIA") are not subject to the aggregation rule. While "laddering" is not discussed in this chapter, you should be aware that the aggregation rule must be taken into account when using this planning technique.

Minimums and maximum premiums

Most annuities have a minimum and maximum premium amount that is allowed by the insurance carrier. The minimum amount is generally not less than $2,000 and may vary depending on whether the funds are qualified or non-qualified; however, there are major exceptions, especially for 403(b) type annuities, and each annuity should be reviewed to determine the minimum amount. Generally, tax-shelter annuities (403(b)) have a very low amount to start, e.g., $50, and additions can also be small as they are most often taken as payroll deductions by the employer. If less than the minimum amount is submitted to the carrier it is generally returned or additions are requested.

The maximum amount allowed is set by the company and it generally varies from $250,000 to $1,000,000 without prior approval of the carrier. Large annuity premiums potentially expose the carrier to additional risks emanating from the death benefits, riders, etc. Variable annuities are treated more like mutual funds and limits may not be imposed.

What are the Different Classifications of Annuities?

Variable annuities

The broadest classification of annuities is between fixed and variable. Variable annuities are securities because as the name implies, their value can vary, positive and negative, from the original amount of premium paid. Variable annuities are oftentimes referred to a "mutual funds inside an insurance wrapper" because, while the earnings are tax-deferred, the underlying assets are the same or similar to those associated with mutual funds, i.e., stocks, bonds, market indexes and general securities. Additionally, the fee structure for variable annuities is similar to mutual funds since they can include an up-front sales charge as well as on-going administrative and money-management fees. In the absence of riders, the variable annuity generally does not carry any guarantees in regard to minimum earnings, death benefits or lifetime income amounts.

Fixed annuities

The fixed annuity's prime characteristic is that it guarantees some minimum earning rate if held for the contractual term, generally defined as the length of the surrender penalty period. The minimum guaranteed growth is most often stated as some base interest rate, e.g., 2.5%, (a) during the period from the initial premium payment until the end of the penalty, and (b) during the total time that the owner holds the annuity in the accumulation phase. It is important to note that some issuer state their guaranteed minimum as a given rate on a percent of the initial premium, e.g., 3% on 90% of the initial premium. It is tempting to conclude that this arrangement would yield a 2.7% minimum guarantee, but doing the arithmetic will yield a much lower minimum guarantee. As we will see later, the index-linked fixed annuity has many of the characteristics of a variable annuity with respect to the earning opportunity, but it still carries some minimum guaranteed earnings rate if held to term. The fixed annuity has sometimes been characterized as offering a "guaranteed return" whereas the variable annuity offers a "guaranteed opportunity" to realize a return.

Single premium immediate annuity

A narrower classification identifies annuities according to function of how they are funded. For example, the Single Premium Immediate Annuity ("SPIA") involves the payment of a single premium followed no later than one year with a stream of income payment. SPIAs can be either fixed or variable and should not be confused with an annuity that is in the pay out phase. While both involve a stream of income payment, the SPIA has no accumulation phase.

Single premium deferred annuity

Annuities, both fixed and variable, may be "single premium" or "flexible premium". The former is referred to as SPDA (single premium deferred annuity) and the contract allows only one initial premium whereas the FPDA (flexible premium deferred annuity) allows additional premiums after the initial. These additional premiums usually must be at least a certain minimum amount and may be limited to one or more years following the initial premium. Additionally, these additional premiums may "roll forward" the surrender penalty period with each addition being treated separately or the surrender schedule may not be extended for the subsequent premiums with the surrender period for all premiums ending at the same time. Additionally, flexible premiums may each be subject to interest rates and other earning limitations at the time they are made, or they may be subject to those of the initial premium.

Tax shelter annuities

A special class of annuities is the Tax Shelter Annuities ("TSA") and is governed by Section 403(b), 457 and others of the Internal Revenue Code. TSAs can be fixed or variable. Generally, TSA are available to the employees of public institutions, e.g., school teachers and policemen, and non-profit organizations, e.g., certain hospitals and the clergy. Premiums are paid in before-tax dollar, making all withdrawal subject to ordinary taxation. The TSA generally can be opened for a very small amount, e.g., $100, and subsequent premiums can also be small. Premium payments are routinely made by payroll deductions. The contribution and withdrawal rules vary widely according to the individual circumstances of the owner

The Single Premium Immediate Annuity ("SPIA")

As indicated above, SPIAs have no accumulation phase and are funded by a single premium that serves as the corpus for a stream of future income payments. One of the payment options available to the owner is selected and the first payment must commence no later than one-year following the payment of the premium. Once the payment option is chosen it generally cannot be changed or accelerated; however, in recent years there have appeared SPIAs that allow for limited changes once the payment start and may also permit a lump-sum payment for the current present value of the future anticipated income streams.

The payments of a variable SPIA may change periodically based on the value of the underlying assets: rising when the value of the assets increases and falling if the opposite occurs. As a general rule, fixed-rate SPIAs are most efficient when interest rates are at cyclical or secular peaks because the entire future payment stream is based on the rate in effect at the time of the initial premium. Locking in interest rate peaks assures the highest payout from a given premium. However, since future interest rates are not predictable with any degree of certainty, picking the peak or near peak could prove difficult. Nonetheless, during period of abnormally low interest rates, e.g., the early 2000's, the SPIA is usually not a popular choice.

As was discussed above, the amount of the non-qualified SPIA payment that is subjected to taxation will be determined by the exclusion ratio. If the life only option were chosen, the exclusion ratio is determined by referencing the mortality tables and making the computation accordingly. If a SPDA and a SPIA are purchased from the same insurance company during the same calendar year, the IRS has ruled that the aggregation rule is not applicable. The payments of a SPIA can be directed to a third party, and some issuers allow payments to be divided and directed to multiple parties.

SPIAs can be used to fund a future stream of income or they can be used to fund a recurring liability. For example, oftentimes a SPIA is used to make the premium payments of a life insurance or long term care insurance policy. Since there are no adverse tax consequences of taking a SPIA payment prior to age 59½, SPIAs can also be used to fund college expenses, alimony and child support, or any recurring liability that the owner wants to put on "automatic" payment. Also, SPIAs are used in "split or combination" annuities which are discussed below. Increasingly, the proceeds from reverse mortgages are used to purchase SPIAs rather than taking the installment payments offered by the mortgagee. Since future payments are generally fixed and certain, the owner of the SPIA knows exactly the amount that will be received in future periods. In recent years, some SPIAs have offered as an additional rider the ability to index future payments to inflation. This rider comes at an additional cost and usually has both an annual and lifetime cap.

Even though a SPIA and the annuitization of an existing annuity can provide the same results, viz., a future steam of income, they should be considered separately. For example, a SPIA's future income stream will be determined by the prevailing interest rate, income option chosen and possibly the medical age of the owner at the time the initial premium is paid. The annuitization of an existing annuity generally cannot occur until after some defined waiting period, typically one to ten years after the last premium payment, and may be subject to terms in the annuity contract such as minimum pay out period, minimum guaranteed rate of return, etc. The consensus opinion among financial services professional is that SPIAs will undergo a surge in use as the baby boomers move from the accumulation phase of their financial cycle to the distribution, or use, phase.

It was mentioned above that the income stream available from a SPIA could be linked to the medical age of the owner-recipient. If a "lifetime" payout option is chose, payment will cease when the owner dies. The sooner death is expected, the greater should be the periodic payments because there will be fewer of them. SPIAs that take into account the medical age of the owner are referred to as "medically underwritten" or "impaired risk" SPIAs because their future payments are increased for shorter life expectancies and decreased as longevity improves. Just the opposite of how premiums are determined for life insurance policies. Some insurance companies will also increase the lifetime payments for tobacco users as opposed to non-users. Generally, the underwriting is not rigid for smaller medically-underwritten SPIAs but as the amount increases so does the rigor of the underwriting.

Traditional Fixed Annuities

Annuities that offer a fixed rate for a defined period of time are generally called "traditional fixed annuities" to differentiate them from "index linked fixed annuities" (discussed below). A traditional fixed annuity may have a fixed guaranteed rate for a short period of time or it may be fixed for a longer period. Additionally, some issuers mix the two into hybrids that may be fixed for a long time period followed by a period of frequent rate changes, or the initial rate will be increased annually according to a schedule that is made part of the contract. As a general rule, traditional fixed annuities rates are set for one year at a time or are fixed for multiple-year period.

The one year, or less frequent, guaranteed rates have given rise to the term "trust me" annuities because the owner trusts the issuer to offer a competitive rate at the end of the one-year period. Since the fixed annuity will always have a guaranteed minimum rate, the fixed, or "crediting", rate that is changed periodically must be at least the minimum guaranteed. Other than the minimum guarantee, the owner is at the mercy of the issuer to set a competitive rate. Some issuers establish “bail out rates” which stipulates that if the renewal rate in any future period is less than the bail out rate, the owner is free to withdraw the funds or 1035 exchange to another annuity with the same or a different issuer without surrender penalty.

Annuities that offer a multiple year rate guarantee, or MYG, wax and wane in importance depending upon the market’s perception of the future direction of rates. MYGs gain favor during perceived high rate period and become less popular during cyclical low rate period. MYGs are commonly used if the owner desires a predictable, and fixed, rate of return during the accumulation phase of the annuity. MYGs are used when constructing a split, or combination, annuity or when laddering a portfolio of assets to return a predictable rate of return over a given period.

The split, or combination, annuity is employed when a given amount of money is divided between a SPIA and a MYG in such a fashion that when the SPIA income stream ends the money placed in the MYG will have grown back to the amount used to fund the two annuities. For example:

> A client has $100,000 in a bank CD on which income taxes must be paid every year. By using the exclusion ratio of the SPIA and the tax-deferred earning of the MYG, the money in the CD can be split between the two annuities so that the after-tax income from the SPIA is equal to, or greater, than that from the CD and the MYG will grow back to the original amount of the CD when the SPIA payments stop. Alternatively, the after-tax payment from the SPIA could exactly equal the after-tax income from the CD and the MYG grows to more than the initial value of the CD by the time the SPIA payments end.

In effect, this technique is simply using the tax advantages of annuities to yield the owner a higher after-tax income. This technique can be used to structure a series of annuities that can be annuitized to replace the SPIA income and which will maintain the income stream far into the future. For example, you might select a 5 year SPIA, a 5 year MYG and a 10 year MYG. At the end of the 5 year SPIA, the 5 year MYG will have a predictable value and can be annuitized for five years until the 10 year MYG matures. As you can discern, future interest rates may have an impact on annuitization payment; thus, the extended split annuity will involve some uncertainty.

Index Linked Fixed Annuities ("EIA")

The index linked fixed annuity is commonly referred to as an equity index annuity, or just EIA. When this annuity was introduced it was linked to an equity index only and thus the reason for the name. As the index linked concept has matured the choice of indices has been expanded to include fixed rate, or bond, indices as well as numerous equity indices, e.g., S&P, DJIA, Wilshire 2000, NASDAQ, and others. It is important to know that the premiums from an EIA is not necessarily invested in equities or bonds, but rather the earning opportunity is linked to movements in the index to which it is linked.

The exact link between the earning potential of the EIA and the index to which it is linked can vary widely among issuers and even annuities issued by the same insurance company. The method used to compute the earnings of the EIA is referred to as the "crediting method" and each method has its own unique set of terms and conditions. In fact, at this time there are over fifty different crediting methods in use and the number continues to expand.

Crediting methods

One of the most popular crediting methods is called the annual point to point annuity and its growth is typically linked to the S&P 500. It works as follows: at the time of the initial premium, the level of the S&P is recorded as the starting point and compared to the level at the first anniversary of the initial premium. The difference is measured and used to determine the amount of the earnings paid into the annuity for the first year. This movement in the S&P may be subject to a participation rate, a cap and possibly a spread. Since EIAs are fixed annuities, the owner is always guaranteed some minimum rate of return even if the index movement is negative over the period. There are also EIAs that will guarantee a certain minimum increase in the index crediting even if the index movement is negative. This guaranteed "index increase" is generally available only for a fee or some other limiting provision incorporated into the annuity's design.

Participation rate

The participation rate is the amount of the movement in the index that the annuity owner is entitled to have credited to the annuity as earning. The participation rate is generally less than 100%. However, in some cases it is stated as 100% participation in an "average", or a "cumulative average", which in mathematical terms is less than a 100% participation rate in the change of the index "point-to-point". The reader should be aware that the use of "100% participation rate" is based on an "averaging method" or may be subject to a "maximum cap". There are a few EIA that tout participation rates in excess of 100%; however, these levels may be "marketing hype" as they also have caps, spreads and/or employ an averaging technique to compute the credited earnings.

Participation rates are generally higher if an averaging technique is used in the crediting method and lower for point-to-point. Also, point-to-point methods are more likely to employ caps than are the averaging methods. The best way to understand EIAs is by examples.

> Assume the index used is the S&P 500 and this index increases 12% during the year, but the participation rate is stated as 80%. In this case the annuity would be credited with an earning rate of 9.6% (80% of 12%). If the participation rate was given as 100% but with a 9% cap, then the amount credited would be 9% since that is the maximum permitted, or the cap. Sometimes both participation limits and caps are used to determine the earnings credited.

Also, some EIAs employ a fee, generally called the "spread", which is subtracted from the earning rate before it is credited to the annuity. In the foregoing example, if the spread were 2% the annuity would be credited with 7.6% (9.6% less the 2% spread) and 7% (9% less 2%), respectively. The participation rates, caps and spreads may be fixed for a specified time or they may be guaranteed for the term of the annuity. Generally, if they are subject to being reset at the option of the issuer, they will also include minimum and maximum amounts that limit their variability. The only way to determine the variables in an EIA is to carefully analyze it and if there is still confusion you should (a) abandon using that annuity or (b) consult with a financial planning professional to ascertain the exact terms and conditions.

Commonly used crediting methods include the point-to-point which may be monthly, one-, two- or even three-year(s) in length, the monthly average, the cumulative monthly average with a high water look back and *ad nauseam*. Parenthetically, the high "water mark look back", or just high water mark, refers to the value being locked in at the highest point during its term if such a point exceeds the minimum guaranteed return. This means that early gains can be "locked in" when the index loses value. Most EIAs guarantee that the annuity value will not decline during a period when the index falls but rather be zero, increase by the guaranteed minimum amount or be the previous high water mark.

The important thing to remember about crediting methods is that any one has a chance of being the best or worse before the fact. Since all are linked in some fashion to a movement in an underlying market determined index that cannot be predicted with accuracy, there is no way to know exactly which one will perform best until after the time period has run. Nonetheless, many people seem to believe that one, or a few, crediting methods are superior to all others with the annual point-to-point reset being the most popular.

At this time the EIA is rapidly becoming the best selling "brand" of fixed annuities as it is promoted to offer unlimited upside potential with no downside risk. EIAs are oftentimes characterized as variable annuities with air bags that protect the annuity owner from market crashes. Since the EIA offers downside protection in the form of a minimum guaranteed rate of return if held to term and participation in the increases of the index to which it is linked, it is the ideal conservative investment for the retirement minded saver that cannot afford loss. The limit on the upside participation is the price, or premium for no-loss insurance, that the owner pays for being immunized against downside risk. This value-proposition of no downside in exchange for limited upside has substantial appeal to savers guarding retirement funds or those near retirement who cannot afford to gamble with their savings. The popularity of the EIA has been bolstered by the recent-year gyrations of the equity and bond markets that have left conservative savers and investors with substantial losses in mutual funds, stocks, bonds and variable annuities.

Total Return Fixed Annuities

Total return fixed annuities (referred to as TRFAs or "turf-uh") are very similar to variable annuities as the earnings are linked to the performance of a bucket of underlying assets, invariably equities or fixed rate investments like bonds. TRFAs guarantee a minimum rate of return. The issuer will take a fee, or spread, from the earnings of the underlying assets as their compensation for guaranteeing the minimum return and for managing the assets. Generally, the buyer of a TRFA can select from more than one bucket of assets and is allowed to re-allocate between the buckets on a periodic basis, usually annually. TRFAs generally offer a fixed rate bucket. The allocation limitations and way earnings are credited can be complex; thus, you should study each carefully to make sure you under their features, benefits and limitations. TRFAs has lost much of their market appeal as the EIA has gained acceptance but remains a viable annuity option for some savers and investors.

Variable Annuities

As stated above, variable annuities are sometimes characterizes as mutual funds with insurance company wrappers that give them tax deferred status. Like mutual funds, they have up-front sales loads, on-going management and expense fees and their growth, or shrinkage, are linked to an underlying pool of assets. The reader should recognize that mutual funds and variable annuities have many common characteristics, except be aware that variable annuities offer the same tax deferred features as fixed annuities whereas mutual funds do not. Also like mutual funds, variable annuities carry the risk of loss unless the buyer chooses one or more of the riders that prevents or reduces loss. These riders are generally minimum guaranteed death benefit; minimum guaranteed income benefit and guaranteed withdrawal benefit.

The guaranteed minimum death benefit warrants that generally the value of the annuity upon the death of the owner and/or annuitant will be the highest year-end value reached by the annuity during the holding period. As the decline in equities market of the early 2000's eroded the value of variable annuities, this death benefit became more important not only to the owner and the issuer, but also to outside third parties and the rating agencies. Some of the variable annuity contracts stipulated that the death benefit was the high water mark less the amount of withdrawals from the annuity. For example, assume the variable annuity had a high water mark of $250,000 but the current value is $150,000 and that the owner withdraws, or more likely 1035 exchanges, $140,000. The remaining $10,000 in the variable annuity also has a death benefit of $110,000 ($250,000 less the withdrawal of $140,000). This $110,000 death benefit is an unfunded general liability of the issuer, unless the risk was re-insured. This unique structure has attracted the attention of investors who are willing to pay the owner more than $10,000 for the variable annuity because it has a large death benefit that will eventually be paid and potentially represents a good investment opportunity if purchased *en masse* to minimize the mortality risk. The regulators and rating agencies have become concerned because of the unfunded liability represents a large potential loss for the issuer. At this time the "secondary market" for underwater variable annuities is developing rapidly. The readers who currently own "underwater" variable annuities with such death benefit provisions should carefully consider the death benefit feature before surrendering or "cashing in" the policy.

Two-Tier Annuities

No discussion of annuities would be complete without mentioning the concept of "two-tier". This brand of annuity can come in any form: fixed, EIA, TRFA, variable or any combination, with or without bonuses and regardless of the age of the owner and/or annuitant. Simply put, the two-tier annuity has two possible outcomes depending upon how the owner takes their money at the end of the surrender period, i.e., when the annuity's term ends. If a lump sum withdrawal, or annuitization of less than a specified number of years, is taken the owner is credited with a lower earning rate than if the proceeds are taken via annuitization for at least the number of years specified in the contract. Additionally, if the annuity paid a premium or interest rate bonus at the beginning, it will most likely be forfeited unless the proceeds are taken via annuitization for the stipulated minimum number of years.

This structure leaves the door open for the owner to be abused in one of two ways: first, if the correct annuitization is not utilized at the term's end, the owner receives a markedly lower earning rate during the holding period and his shortfall accrues to the issuer as added profits. Second, even if the annuitization is taken, the issuer has the latitude of linking the future income payment in annuitization to a below-market rate of interest which has the same effect as paying the lower rate during the accumulation phase of the annuity. Either way, the owner stands to earn a below market rate of return whether he withdraws lump sum or via annuitization. This author does not recommend two-tier annuities because of the unfavorable withdrawal provisions.

Who are the most likely candidates for annuities?

By definition fixed annuities are designed for long term savers that are risk averse and can benefit from the triple compounding of this financial product. The variable annuity is not for the risk averse but does offer the same triple compounding inherent in the tax deferred annuity. Early withdrawal can have consequences as there may be surrender penalties assessed, penalty taxes will be assessed by the IRS in certain situation, and the earning become subject to ordinary taxation. Obviously, a client planning for retirement should first maximize their contributions to qualified pension plans as this is generally done in pre-tax dollars and oftentimes is accompanied by matching money from employers. Arguments have been made that the inability of take advantage of capital gains taxation (usually made in discussions of variable annuities) have been offered as reasons not to purchase annuities; however, empirical analyses indicates that their shortcomings pale when compared to the deferral of taxes until the funds are withdrawn.

Those using annuities for retirement planning can choose when they take disbursements and pay the taxes. There is no limit on the amount of money that can be placed in a tax deferred annuity nor are there requirements that the fund be withdrawn at any given future time. Annuities offer a way to reduce the taxes that are paid on Social Security benefits because as long as the money is in deferral, the accumulation period, it is not reportable income when computing the portion of Social Security benefits that are subject to taxation. Also, annuities are the only financial product that can be turned into a lifetime income – an income that cannot be outlived and future income payments are unconditionally guaranteed by an insurance company.

Annuities are also appropriate products for conservative savers who are already in retirement but want to safeguard their principal and have an opportunity to earn a market rate of return on their savings. By carefully choosing traditional fixed, EIAs and TRFAs the cautious saver can craft a diversified portfolio that can be managed virtually risk free and defer all taxes until the funds are withdrawn as needed. It should be realized that annuities, not even EIAs or TRFAs, are expected to return the same as a well diversified equity or mutual fund portfolio over a long period of time because of the immunization against loss. However, there is ample evidence to support that the rate of return on fixed annuities, especially on EIAs and TRFAs, eclipse the earnings from taxable fixed income savings products like bank CDs, Treasury Bonds and other fixed rate conservative investments.

There is a raging controversy about whether or not annuities are appropriate for IRA and other qualified funds. The opponents argue that these investments already have tax deferral and putting them into annuities would be double kill. This overlooks the most important attribute of an investment or saving account: what is the rate of return? Does it really make any difference whether or not you have superfluous tax deferral if the rate earned beats the next best alternative of the same risk level? If an annuity can return a higher holding period yield than a bank CD, mutual fund or any other investment, then it is appropriate for qualified money because the owner will have a bigger nest egg at the end than otherwise. Likewise, if the annuity protects the owner from downside risk that otherwise cannot be afforded, then it offers the owner “sleep insurance” that other investments cannot and is appropriate for qualified money. Additionally, an annuity is the only investment that can provide an income that cannot be outlived, and this may be important to a client that fears outliving their money.

If people only knew

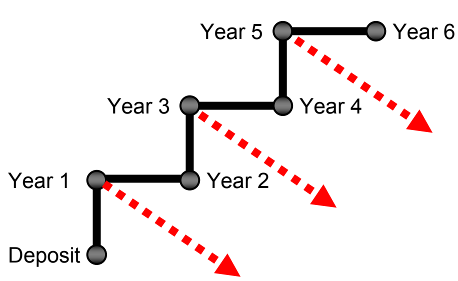
If savers and investors only knew that the stock market was going to have a significant decline during 2000-2002 would they have chosen to reposition investments with no protection into some sort of an annuity (probably an EIA) due to the principal protection and potential for good upside growth?

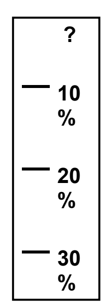
5-year historic review of the S&P 500

- 14.71% (2003)
- -22.09% (2002)
- -11.88% (2001)
- -9.10% (2000)
- 21.04% (1999)

The average rate of return over the five year window was a negative1.45%.

If only we would have known, we all would have moved some or all of our money to principally guaranteed annuities (this also includes money in 401(k)/profit sharing plan or IRA). The following is how a typical annual point-to-point annuity protects a client’s invested money from downturns in the stock market.





In year one if the measuring index goes up, so does the value of the annuity. If in year two the market goes down, it does not affect the value of the annuity. This is an annual reset that will always guarantee that your money will not go backward in years when the stock market does not perform well.

	$100,000 Invested in S&P	**$100,000 Invested in EIA**
Year	**A**	**B**
1 (1999)	**$114,710**	**$112,000**
2 (2000)	**$89,370.56**	**$112,000**
3 (2001)	**$78,753.34**	**$112,000**
4 (2002)	**$71,586.78**	**$112,000**
5 (2003)	**$86,648.64**	**$122,080**

A good saying for savers when the market goes negative is that "zero is the hero." As you can see by looking at years 2-4, if the investment return was zero (something most investors do not like), you would have been very happy. Annuities, and EIAs specifically, are not the perfect investment, but it is very easy for savers (especially those in or nearing retirement) to justify having some portion of their investment portfolio inside an investment that will not go backwards. Again, if we only knew, wouldn't we all have had some of our money in principally guaranteed investments in 2000-2002?

Summary

Annuities come in many varieties, classifications and versions, but they all have in common the feature of tax deferral. Annuities have a place in the financial plans for a large percentage of the individuals that are saving for retirement or are already in retirement, and who cannot afford to take the risk of losing some or all of their investment. Annuities are the only investment that offers triple compounding, free immunization against downside risk, zero up-front sales fees, the opportunity to earn a competitive or better rate of return, and can be converted into an income that cannot be outlived.

While annuities are not for everyone, they are appropriate for conservative savers who cannot afford market or interest rate risks and can use the tax deferral features to minimize, or better manage, their tax liability. Annuities are appropriate for both qualified and non-qualified moneys if the after tax rate of returns are acceptable when measured against comparable options. The argument against using annuities for qualified funds because of the superfluous tax deferral misses the *raison d`etre* of an investment: the rate of return.