

# Variable Annuities

- ◆ Introduction
- ◆ Settlement Options
- ◆ Methods of Buying Annuities
- ◆ Tracking Separate Accounts
- ◆ Suitability
- ◆ Tax Deferred Annuities

## **Using this study guide.**

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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## Variable Annuities

### Introduction

Annuities are products insurance companies create to help clients who need protection against untimely death and/or professional advice in managing money. Life insurance allows clients to manage the risk of financial problems for survivors by paying premiums for the guarantee that upon death a predetermined sum will be paid to any beneficiaries. Annuities allow clients to manage the risk of financial problems that may occur if the client lives so long he/she runs out of money. With increased longevity, money problems of the elderly have taken on new challenges. Annuities are contracts with insurance companies that guarantee payments for life. The insurance company promises to pay a predetermined amount to the client beginning on a preset date and continuing no matter how long he/she lives. Insurance can protect against dying too soon and annuities can protect against living too long.

An annuity combines investment and insurance features. It is a contract that enables the professional money management experts of an insurance company to make and uphold its promise of lifelong payments to clients. The insurance company puts money from clients' payments into its investment portfolios. A **fixed** annuity is one in which the insurance company guarantees the investor that it will pay him/her a specific amount of payment beginning on a preset date. A **variable** annuity is one in which an investor's money will grow at a rate based on the performance of a specific portfolio of the insurance company. It carries no guarantee of a pre-determined amount, but will vary based on the performance of the portfolio. A variable annuity is like a tax-deferred mutual fund. The maximum sales charge is 8 ½ % for the first twelve years. Breakpoints, LOIs and Rights of Accumulation are also available.

The client does not have to retire to receive the payouts from an annuity, but may choose one of several ways of receiving his money. The fact that the payout of a variable annuity varies based on portfolio performance is referred to as **investment risk**. The risk lasts during the time the client is making payments (known as the **accumulation period**) and the time he/she is receiving payments (known as the **annuity period**). For this reason, the Securities and Exchange Commission labels variable annuities as securities and only registered representatives may sell them. In contrast, fixed annuities are not

securities. Insurance companies maintain the risk factor of fixed annuities by guaranteeing payouts no matter what. Both fixed and variable annuities are insurance products and the appropriate state insurance license is needed to sell them.

Combination annuities combine fixed and variable features. Clients who buy combination annuities receive some fixed amount plus a variable amount. The variable side protects against inflation and the fixed side protects against deflation.

Variable annuities are not recommended for short term investing. They are mostly used for long term funding for retirement. Invested monies will grow based on the performance of a separate portfolio used only for variable annuity contract holders. This account is referred to as the **separate account**. In contrast, the **general account** is where all insurance premiums of every kind are deposited. It is a huge fund that is invested very conservatively so that adequate monies are available to settle claims.

Monies in the separate account are used only for variable annuity clients' investments and are handled less conservatively in an effort to have better than average long-term growth of capital. Clients buying variable annuities must agree to assume this investment risk. With both the fixed and the variable accounts, the investor is guaranteed to continue to receive payments once they are begun. The **amount** of the payments is guaranteed only for the fixed annuity. The contract *may* have a provision for beneficiaries to receive the payments after the death of the client, though this is not always the case. The **mortality guarantee** is that the annuitant cannot outlive the payments; the company will keep paying as long as the annuitant is living.

If a client lives longer than the insurance mortality statistics indicate, he/she "wins." That is, he/she receives more in payouts than the value of what was paid in. The negative side of annuities is that the client may not do this. He/she may in fact die earlier than insurance mortality statistics indicate or may die shortly after payments begin and receive far less than he/she paid in. Annuity contracts are written so that the annuitant gives up control of his/her principal when annuity payout begins. If an annuitant dies, payments will stop and the insurance company will keep the undistributed part of the account. In such a case, the insurance company "wins"; that is, the company pays out less than it took in.

## Settlement Options

Because of this negative feature, most annuity clients choose a method of payment that guarantees the continuation of payments to a beneficiary. Methods of payout are called settlement options and include straight life annuity, life annuity with period certain and joint and survivor annuity. The **straight life annuity settlement option** guarantees payments for life but no payments after death. It has the most risk because the investor may not receive as much payout as he/she has paid in. One compensation for this risk is that the monthly payment at retirement is the largest amount of any of the settlement options.

The **life annuity with period certain** is an annuity that will be paid for as long as the client lives and if he/she dies before a specified period of time, the payments will be made to a beneficiary until the end of the specified period of time from the day the annuity payout period began. A life annuity with 15 years certain would pay for client's lifetime and if the client died after 10 years, payments would continue for 5 more years, then stop. If the client lived more than 15 years, payments would continue until the client died and then discontinue and there would be no payouts to beneficiaries. The monthly benefits on life annuities with period certain are **less** than the monthly benefits of straight life annuities due to the guarantee of a certain number of years of payouts. The payouts are reduced because the risk to the client has been reduced.

In the case of the **joint and survivor annuity**, the client will be paid a monthly benefit until his/her death and a predetermined percentage of what was the monthly payment will be paid to a survivor until that person dies. The percentage will be the amount agreed upon by the client and the insurance company. In general, a joint and survivor 50% annuity may be all that is necessary because living expenses of one survivor from a husband-wife duo decrease when one party dies. If a couple chooses the joint and survivor 100% annuity, payouts will be lower than those of a straight line annuity because the risk has been reduced.

**Lump sum settlements** are also available. This means one payment, all at once. In this case, the client would receive all of the original capital plus earnings. There is no risk of getting less than a full return of the invested capital plus earnings. One of the disadvantages of a lump sum payment is that there is a considerable tax liability in the year the payout takes place. Both

fixed and variable annuities allow for any earnings during the accumulation period to have tax deferrals until payouts begin. This leaves more money in the account to grow. At the time of payout, earnings are taxed as ordinary income. Lump sum settlements are not chosen often because a considerable portion of the investor's earning may go to taxes. With the straight life annuity, a joint and survivor annuity or a period certain annuity, at least the tax liability is spread over many years and is less than with a lump sum settlement. Additionally, if a retiree chose a lump sum settlement, he/she would need to find an investment that would allow the lump sum money to accumulate. To leave it as uninvested cash would be a big mistake and would not take advantage of the earning power of the money. This is another reason lump sum settlements are not chosen often.

A method known as **installments of designated amounts** is also available. A predetermined amount is paid every month until the account is empty, then no other payments are made. Also available for payouts is an option called **investment income**. The principal is left untouched and payments made up only of the income are paid out. At the client's death, the principal amount is paid in a lump sum to the beneficiary. Installments of designated amounts and the investment income options are usually more advantageous to survivors than to the clients.

## Methods of Buying Annuities

The three ways of buying an annuity are single payment immediate, single payment deferred, and periodic payment deferred. With the **single payment immediate**, the client pays a single sum of money and monthly payouts begin within a very short time period (usually 30 days). This type method is not recommended for a person who is still in the earning period of life or a person who does not plan to retire for 10 to 40 years. This method would be appropriate for a person who is near retirement age and wanted payouts to begin in the near future.

With the **single payment deferred**, the client gives a lump sum of money to an insurance company which invests it until time for payouts to begin. The time period between the lump sum payment and payouts is called the deferral period. A client who is 40 years old and chooses a \$5,000 single payment deferred variable annuity will (at age 65) have amassed 25 years of portfolio earnings based on the portfolio's investment performance for those years. At age 65, the client will decide which settlement option best fits his/her needs. Lottery winners and high paid professional athletes often use single payment deferred methods of buying annuities.

The **periodic payment deferred annuity** is most often chosen by clients who do not have large sums of money to work with but want to systematically put money aside on a monthly, quarterly or annual basis. Whenever the client adds to his/her account, the insurance company invests the money in the separate account of the variable annuity. The principal accumulates earnings and the client chooses a settlement option at a future date. No income taxes are due and no payouts occur during the accumulation period. The client will be taxed at ordinary income tax rates at the time he/she takes possession of the earnings. Unlike mutual funds, the earnings on periodic payment deferred annuities are **tax deferred**. All dividends and capital gains distributions for mutual funds are taxed in the year in which paid whether or not they are reinvested. When payouts begin for the annuity, the IRS determines which part of the monthly payment is earnings on the principal (taxable) and which part is the return of principal (not taxed).

If a client invested \$50,000 in an annuity which appreciated to \$150,00, the initial \$50,00 was after tax money (which the IRS calls **non-qualified**) and taxes must be paid on the \$100,000 earnings at ordinary income rates. If the

annuity happened to be a 403(b) or 501(c)(3), the initial \$50,000 would have been pre-tax money (which the IRS calls **qualified**) and the client owes taxes on the full \$150,000. IRAs' Keoghs, 401(k)s, and others also operate this way.

If a client wanted to withdraw \$25,000 of the total prior to the payout date, the IRS uses the “**last in, first out**” rule so that the withdrawn portion is treated as earnings and is taxed at ordinary income rates. If the client wants to withdraw \$125,000, the first \$100,000 is treated as earnings and taxed, but the other \$25,000 is considered part of the original principal and is tax-free. The partial withdrawal is subject to a 10% early penalty if the investor withdraws before age 59 ½, but it applies only to the taxable earnings and not the principal. This is true if the money is taken directly or indirectly. **Indirectly** is the terminology used when the annuity is pledged as collateral for a loan. The loan proceeds could be fully or partially taxed, sometimes plus the penalty. The moral here is that the best scenario is for the client to leave the annuity alone until retirement and take one of the settlement options at that time.

In the case of a mutual fund where an investor has an initial investment of \$50,000 and it accumulated to a value of \$150,000 and the investor reinvests \$10,000 of dividends and \$50,00 of capital gains, the taxes have already been paid on the principal, dividends, and capital gains. This creates a cost basis of \$110,000 and if the investor redeems his mutual funds shares for \$150,000, capital gains taxes will be due only on the remaining \$40,000. This would be considered a long-term capital gain and would not be subjected to any 10% penalty. The IRS allows the use of the identified shares method if a client wants to liquidate only part of his/her shares. The client may identify which shares are being sold or redeemed. This could be for partial liquidation of stock or bond holdings. If this is not done, the IRS assumes “first in, first out” and taxes accordingly.

If a client wishes to terminate the contract and surrender the annuity during the accumulation period, he/she may do so without losing any rights to the money invested or the earnings. But the earnings are fully taxable as ordinary income in the year the investor terminates the contract and may be subject to an early penalty, depending on the client's age at the time of termination.

In the case of death of a client during the accumulation period, most contracts stipulate that a death benefit be paid to the client's beneficiary in the amount equal to the total of all the investments made plus the earnings to date.

If the separate account has lost money, the beneficiary is guaranteed the return of the full principal at a minimum. This is referred to as the **death benefit provision**. The beneficiary must pay taxes on the earnings just as if the client had surrendered the annuity during the accumulation period.

## Tracking Separate Accounts

Insurance companies use an accounting method called **accumulation units** to keep track of a client's share of the separate account. Each day at four o'clock p.m. Eastern time, an insurance company's separate account portfolio is valued and its net asset value per accumulation unit is determined. This happens in the same way as if the shares were mutual fund shares. All annuity purchases will be filled at the next calculated net asset value after receipt of the purchase order and appropriate sales charges will be added.

In the case of a surrender, the client would receive the prevailing net asset value of his/her accumulation units next calculated after receipt of the order to cash in. **Forward pricing** applies to annuities just as it does to mutual funds.

The value of the portfolio and the net asset value of each of the accumulation units will have increased over time if the insurance company has invested wisely. The net asset value of the accumulation units on the day the client surrenders them will include all the earnings that the client deserves based on his/her proportionate share of ownership. The amount above the investor's principal is taxable as ordinary income. In order to calculate the value of an ownership interest in the separate account at any time, multiply the number of accumulation units times the net asset value (NAV) of each accumulation unit. This is referred to as the **value of the account**.

On the date payouts are to begin, the insurance company calculates the total value of the accumulation units owned and the client chooses a settlement option. The process of changing the contract from the pay-in part of the contract to the pay-out part is called **annuitizing**. On the same day, the insurance company uses a complicated mathematical process to convert the accumulation units into a fixed number of annuity units. After this fixed number is identified, the number will remain constant for the client's lifetime. Any variation of the payout will occur when the value of each unit varies, not because the number of units varies. The change in value results from the performance of the insurance company's separate account. If the performance

rises, the payout will increase; if the performance drops, the payout will decrease, and if the performance is exactly as expected, the payout remains the same. Some contracts call for the payment to change monthly; some call for it to change quarterly, semi-annually or annually.

The **assumed interest rate (AIR)** is the amount it is assumed the separate account will earn. The initial annuity check will be calculated on the AIR and the monthly check will vary based on the actual investment results of the separate account. If the account earns more than the AIR in the second month of the payout period, the annuity check will increase. If the account earns less than the AIR in the second month, the annuity check will decrease. If the account earns exactly the AIR, the second annuity check will be the same as the first one.

Form 1099 is used to inform clients the taxable amount of the annuity payments received during the year. The figure is determined by actuaries at the insurance firm. The difference between the total value of the account and the cost basis is taxable as ordinary income and is immediately taxed if taken as a lump sum. Some tax exclusions apply to clients who take the payout in monthly payments. The settlement option must also be considered. The Treasury life expectancy multiple based upon the age and sex of the client is also a factor. These things combine to influence the taxable and non-taxable amount of the total payments. The most benefit is to the investor who takes the payout in periodic payments, not lump sum.

## Suitability

Variable annuities are appropriate for clients who want to make money but defer the taxes on it or who want to invest and share in the market performance of the investment. Also, variable annuities can be beneficial to those who want professionals to make the investment decisions for them instead of having to make those decisions for themselves. Variable annuities are very flexible. The client can end the contract at any time and still get back the principal and earnings. Payouts may begin at any age and the amount of the payout is based on life expectancy at the date chosen. The client may select the settlement option that best meets his/her needs. The agreement allows flexibility of choosing the age at which surrender of the contract or annuitization will occur.

Annuities should not be considered short term investments and are not appropriate for clients who want to make quick profits. Variable annuities are long term vehicles.

A common risk of all fixed return investments is that the rate of return will not equal inflation and the client who invests in fixed securities may not be keeping up with inflation. A common risk of a variable annuity is that after investing, the market may take a downward turn and the client may end up with an account that is worth less than the principal amount of the investment. A possible solution to these risks is to invest half one's money in a fixed account and the other half in a variable account. This is referred to as a **combination annuity**; the fixed portion may protect the client if the market is bad and the variable portion can help offset purchasing power loss during an inflationary period. Combinations other than 50/50 may be used to protect clients who have different concerns relating to inflation and risk of loss.

Variable annuities must have a prospectus before sale may begin. Since an annuity is basically a tax-deferred mutual fund, most separate accounts must be registered with the SEC as open-end investment companies with long-term growth objectives. However, the prospectus of an annuity will differ from that of a mutual fund. An annuity is an insurance product and guaranteed payments for life or other settlement options certainly will not appear in a mutual fund's prospectus. Also, unlike a mutual fund, taking dividends and capital gains in cash is not possible for variable annuities. The prospectus for a variable

annuity will make full disclosure of the likenesses to mutual funds as well as the differences.

Some of the benefits of insurance products are also benefits of annuities and the appropriate charges are made against the portfolio. These include the mortality guarantee, the expense guarantee, the death benefit, and the non-forfeiture provision. The **mortality guarantee** is the insurance company's promise that a client will have a monthly check as long as he lives. The **expense guarantee** is the insurance company's promise that regardless of the company's actual experience, the operating expenses to the client will never exceed a set amount, normally 1%. The **death benefit** guarantees that during the accumulation phase of the account, the investor's beneficiary will get back no less than the amount of his investment if the investor dies before annuitizing. The expense limitation of 1% of average annual net assets includes the cost of these three benefits. The **non-forfeiture** provision means that, during the accumulation phase, whatever the client has invested in the annuity belongs to the client and he/she can do with it whatever he/she wishes. Once the account is annuitized, the client loses control of it.

## Tax-Deferred Annuities

Sections 403(b) and 501(c)(3) of the Internal Revenue Codes refer to retirement plans for any public school employees as well as employees of certain non-profit and other tax-exempt organizations such as hospitals, religious groups, humane societies, charitable groups, museums, and symphonies. These special retirement plans are called **tax-deferred** or **tax-sheltered annuities** and are different from ordinary variable annuity products. One difference is that employees invest before personal income taxes are figured. That is, monies invested in tax-sheltered programs are pre-tax dollars. Investments in ordinary annuities are after-tax dollars, but earnings are deferred until payouts begin or the contract is surrendered. Tax-deferred contributions are actually made through salary reductions. All taxes on the original contributions and on any earnings are deferred until surrender or payout at which time ordinary income taxes are levied on the complete amount of payout because the cost basis is zero.

An **exclusion allowance** allows employees to retroactively include prior periods of employment for tax-deferred contributions. Additionally, these qualified annuities are available to all full-time or part-time employees, regardless of length of employment and income to be included in this plan must be from the participating organization, not outside employers.

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