

# Phoenix AAI Chapter Meeting



## **Deciphering Annuities and Other Insurance-Based Investments**

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- Board member of Phoenix chapter of American Association of Individual Investors (AAII), a national non-profit education organization
- Teaching financial literacy and wellness beginning in 1982

Disclaimer: This general educational presentation is not intended to be tax, legal, or investment advice.

# Today, My Goal Is for You to...



- **Know answers to FAQs about annuities, and other insurance products.**
- **Learn how to evaluate annuities in terms of their purpose and cost - and whether or not an annuity might be a good financial product for you.**
- **Understand your possible choices if you bought an annuity which you no longer need, or want to own.**

# Agenda



- **Annuity Fundamentals**
  - Definition & history
  - Guarantees & liquidity
  - Risks & costs
  - Running the Numbers
- **Deconstructing an Annuity**
  - A chassis with options
  - Features & benefits
- **Types of Annuities**
- **1035 Exchange Rules**

# Many Types of Annuity Products



- Immediate annuity
- Deferred annuity
- Fixed annuity
- Variable annuity
- Index-linked annuity
- Income guaranteed annuity
- Longevity annuity
- Inflation protected annuity
- Policies with LTCi-linked benefits

# Some Recent AAI Articles on Annuities



- **How to Create Your Own Pension: A Closer Look at Immediate Annuities (Nov 2009)**
- **Magic Numbers: Reduce the Math of Annuities to Simple Arithmetic (Oct 2011)**
- **The Role of Inflation-Indexed Annuities (Mar 2011)**
- **Equity-Indexed Annuities (June 2010)**
- **Annuities: The Good, the Bad, and the Ugly (July 2006)**

# What's Your Annuity Information Quotient (IQ) ?



**Annuities can protect you from stock market losses**

**True or False?**

# Annuity Fundamentals – What Are the Guarantees?



- An annuity contract guarantees a certain payout over a certain period of time.
- After annuitization, the contract guarantees a fixed rate of return.
- A deferred fixed annuity guarantees a fixed rate of return.
- Some deferred variable annuities allow you to add (for an extra fee), a guaranteed return of your investment principal, under certain conditions.

# What's Your Annuity Information Quotient (IQ) ?



**Annuities are liquid investments that allow you to get all of your money at any time, regardless of your age.**

**True or False?**

# Annuity Fundamentals - Liquidity



- Although you may cashout a deferred annuity at any time, you may not get all your money back.
  - Surrender charges on are usually 7-10% of the account balance in the 1<sup>st</sup> first year, gradually decreasing over the next 7-10 years.
  - Early withdrawal often voids or reduces annuity guarantees.
  - Withdrawals before age 59½ trigger IRS penalty of 10%.
- Once annuitized, an annuity contract is locked into a set payout schedule.

# Annuity Fundamentals – What Is an Annuity?



- An annuity is a contract between you and an insurance company to hold and distribute money.
- In a fixed annuity, the money is guaranteed to grow at a fixed interest rate.
- In a variable annuity (usually)
  - Guaranteed, future minimum income stream.
  - Plus, potential for additional gain depending on the performance of the annuity's subaccounts.

# Annuity Fundamentals – Accumulation Phase



- In a fixed annuity, the money is held in the insurance company's general account.
  - They invest the money in fixed income investments.
- In a variable annuity, the contract establishes a “separate account” in which to hold the investment vehicles (annuity subaccounts).
  - You select the subaccounts.
  - Investments in the subaccounts are managed by mutual fund companies.

# Annuity Fundamentals – Distribution Phase



- When a contract is “annuitized”, you give the money to the insurance company in exchange for their promise to pay you a certain amount of money over a period of time.
- You own a promise. The insurance company owns the money.
- Two 2 possible distribution models
  - Immediate annuity pays out immediately
  - Deferred annuity pays out at end of the term. Money compounds tax-deferred inside the annuity “wrapper”.

# What's Your Annuity Information Quotient (IQ) ?



**What happens to the money you have invested in an annuity if the insurance company goes under?**

- A. You lose it all.**
- B. It's protected by the FDIC.**
- C. Up to half of your investment is protected.**
- D. It depends on what you own.**

# If Your Insurance Company Goes Bankrupt...



- **Variable annuity**
  - Your money is held in separate accounts and won't be affected by bankruptcy.
- **Fixed annuity or annuitized contract (i.e.. receiving annuity payments)**
  - Your money is held in the insurance company's general account.
  - State insurance guaranty associations provide a safety net.
  - In Arizona, coverage limit is \$100,000 for either the annuitized contract or the cash value of an annuity.

# What's Your Annuity Information Quotient (IQ) ?



**Annuities are new financial products created in response to stock market volatility and disappearing pensions.**

**True or False?**

# Annuity Fundamentals – Early History



- **In Roman times, speculators sold annua, or annual stipends.**
  - Buyer paid a lump sum for a contract with a fixed yearly payment for life.
- **In the Middle Ages, a tontine was used to fund wars.**
  - Participants bought a share of a life annuity. As participants died off, each survivor received a larger payment. The last survivor receiving the remaining principal.
- **In the 1700s and 1800s, annuities were popular in European high society, to protect from financial ruin.**

# Annuity Fundamentals – More Recent History



- During the Great Depression, US investors bought annuities to protect themselves from financial ruin.
- Railroad Retirement Act (pension plan) and Social Security began in the 1930s
- Major League Baseball Players Annuity and Life Insurance Plan began in the 1940s.
  - In 1957, the plan was renamed Major League Baseball Players Benefit Plan

# Annuity Fundamentals - Concepts



- Pooled risk
- Risk transfer
- Time value of money
  - Power of Compounding
  - Present Value of future annuity payments
  - Future Value of money
- Tax considerations

# Insurance Concepts – Risk Management



- **Pooled risk**
  - Your risk is pooled with other policyholders.
  - People who die early subsidize the payments of people who live longer.
- **Risk transfer**
  - Longevity may be your greatest risk (outliving your money).
  - So you're willing to pay the insurance company to take the risk that you will live a long time

# Annuity Concepts – Payout Risk



- **Buying an annuity:** You bet that you'll live a long time and get back the principal, plus interest and more. If you live to age 100+, you win big.
- **Writing an annuity:** The insurance company bets the policyholder will die at their normal life expectancy (or sooner) which gives them a profit. If you die shortly after buying the annuity, the insurance company wins big.

# What's Your Annuity Information Quotient (IQ) ?



- **What are the insurance company's other risks in writing the annuity contract?**
- **What are your other risks in buying the annuity contract?**

# Annuity Concepts – Payout Risk



- **Insurance company's risks**
  - Interest rates
  - Obsolete underwriting guidelines (people living longer)
  
- **Your risks**
  - Inflation
  - Liquidity
  - Opportunity cost (you make a better ROI)
  - Insurance company bankruptcy

# What's Your Annuity Information Quotient (IQ) ?



**If a 65 year-old man invests \$100,000 in a plain vanilla, immediate annuity (with lifetime payout) today, how much would he receive in annual payouts?**

- A. Less than 3% of his initial investment**
- B. Exactly 3% of his initial investment.**
- C. More that 3% of his initial investment.**

# Annuity Fundamentals – Factors in Payout



- Payout depends on life expectancy, which is 22.3 years for a 65-yearold man.
- Payout is both principal and interest.
  - Plain vanilla immediate annuity typically pays back \$0.95 to \$0.98 cents on every dollar in the lump sum.
- Insurance companies invest about 70% of the general portfolio in AAA corporate bonds.
  - Strong correlation between immediate annuity payouts and current 10 year corporate bond rates.

# What's Your Annuity Information Quotient (IQ) ?



At what age would you receive the highest annual payout based on the same initial \$100,000 investment?

- A. 65
- B. 70
- C. 75

# Annuity Concepts – Calculating Payouts



- **Higher payout for shorter lifetime. Life expectancy**
  - 65-year-old man is 17.2 years
  - 75-year-old man is 10.6 years
  - From Social Security life expectancy table
    - <http://www.ssa.gov/OACT/STATS/table4c6.html>
- **\$100,000 immediate annuity at 3%, annual payout**
  - 65-yearold man about \$7,500
  - 75-yearold man about \$10,000.

**Online calculator for immediate annuity**

<http://www.dinkytown.net/java/ImmediateAnnuity.html>

# What's Your Annuity Information Quotient (IQ) ?



**Who would receive the larger annual payments from an immediate annuity?**

- A. 65-year-old man**
- B. 65-year-old woman**

# Annuity Concepts – Calculating Payouts



- Higher annuity payments for men because men have shorter life expectancies. Life expectancy for
  - 65-year-old man is 17.2 years
  - 65-year-old woman is 19.9 years
  - From Social Security life expectancy table
- \$100,000 immediate annuity at 3%, annual payout
  - 65-year-old man about \$7,500
  - 65-year-old woman about \$6,800.

<http://www.ssa.gov/OACT/STATS/table4c6.html>

<http://www.dinkytown.net/java/ImmediateAnnuity.html>

# Annuity Fundamentals – Time Value of Money



- **Purchasing Power**
- **Compounding vs Simple interest**
- **Present Value future stream of annuity payouts**
- **Future Value of a stream of equal payments**

Definitions and financial formulas

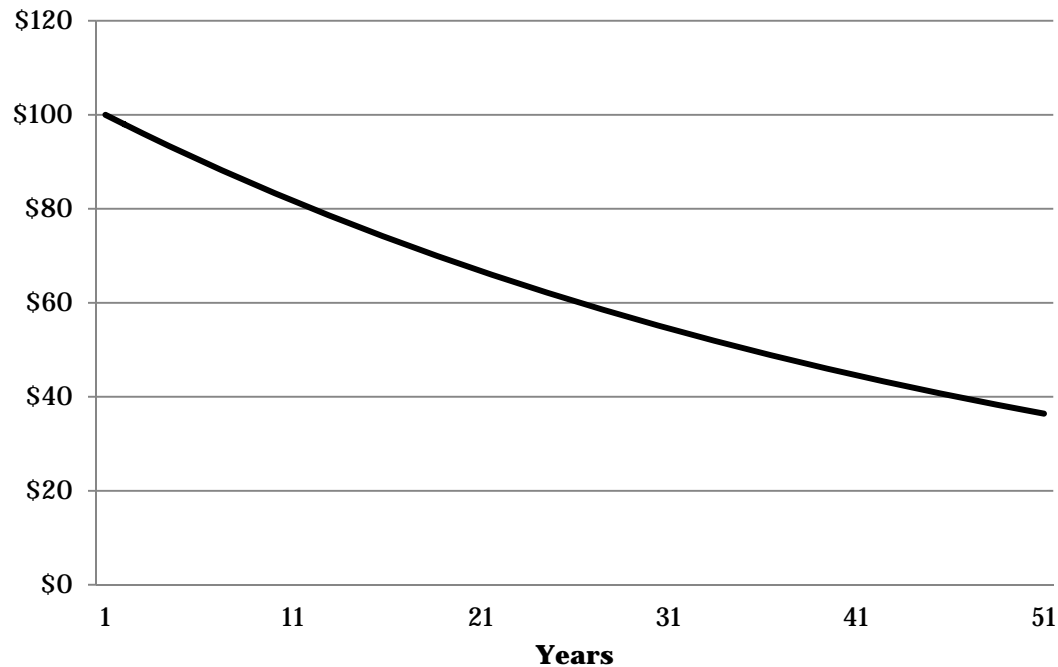
[http://en.wikipedia.org/wiki/Time\\_value\\_of\\_money](http://en.wikipedia.org/wiki/Time_value_of_money)

**Magic Numbers: Reduce the Math of Annuities to Simple Arithmetic (Oct 2011)**

# Concepts – Inflation, the Silent Killer



**Purchasing Power of \$100 Over Time**

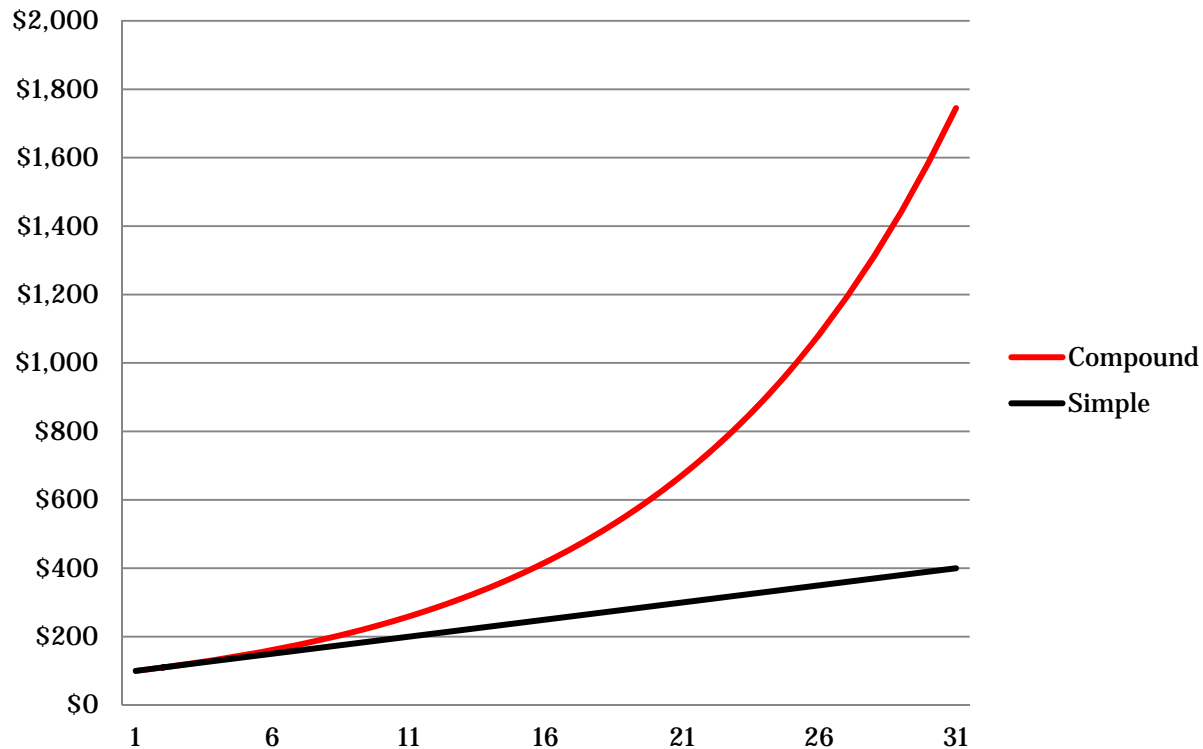


**Money is worth more today than tomorrow**

# Concepts – Power of Compounding



## \$100 Growing 10% Per Year



# Immediate Annuity – Calculating Payout



- Exchange a lump sum of money for a guaranteed stream of income over a period of time, either a set term or the annuitant's lifetime.
- The payment amount, time period, and rate are set at time of purchase.
- Plain vanilla, immediate annuity typically pays back 95-98% of the lump sum of money (over on a set period or your life expectancy).
- Annuity rate depends on the current interest rate.

# Calculating Present Value of an Annuity Cashflow



Present Value of stream of fixed, future annuity payments

$$PV = - ( pmt / rate ) * [ 1 - [ 1 / ( 1 + rate ) ] ^ { nper } ]$$

where pv = present value, pmt = payment,  
rate = rate per period, and nper = number of periods

Online calculator

<http://www.calculatorsoup.com/calculators/financial/present-value-annuity.php>

# What's Your Annuity Information Quotient (IQ) ?



**Most immediate annuity payments keep up with inflation.**

**True or False?**

# Annuity Fundamentals– Inflation Protection



- **Standard immediate annuities only guarantee a fixed payout.**
- **Some immediate annuities offer cost-of-living adjustments that boost the payouts to keep up with inflation.**
  - **The annual adjustment is usually either a fixed % per year amount, or is linked to the CPI.**
  - **The tradeoff is the initial annuity payouts are smaller (relative to the same premium dollar).**

# Calculating Annuity Present Value w/ Growth



## Present Value of annuity cashflow, growing at set rate

$$PV = - [ \$pmt / (\$rate - \$growthrate) ] * ( 1 - [ (1 + growthrate)/(1 + rate) ]^{nper} )$$

Where PV = present value, pmt = payment, rate = rate per period,  
growth rate = growth rate per period, and nper = number of periods

### Online calculator

<http://www.calculatorsoup.com/calculators/financial/present-value-annuity.php>

# Deferred Annuity – Calculating Future Value



## Future Value of stream of payments at fixed growth rate

$$FV = -pv * (1 + rate)^{nper} - pmt * (1 + rate * type) * [ ((1 + rate)^{nper} - 1) / rate ]$$

FV = future value, pv = present value, rate = rate per period, nper = number of periods, pmt = payment amount, and type = 1 if payments are made at the beginning of each period or type = 0 if payments are made at the end of each period

### Online calculator

<http://www.calculatorsoup.com/calculators/financial/future-value.php>

# Why Understand the PV and FV Calculations?



- Define the financial opportunity costs in choosing one alternative financial decision (or product) over another.
- Understand what you're giving up versus what you're getting.
- Understand what you're paying, i.e. the cost of risk transfer.

# What's Your Annuity Information Quotient (IQ) ?



**How are annuity withdrawals taxed?**

- A. Same tax rules as for IRA withdrawals**
- B. Different tax rules for annuities**
- C. It depends**

# Annuity Fundamentals – Tax Rules



- **Tax-Qualified vs NonQualified (NQ) annuities**
- **Qualified annuity**
  - Annuity inside a tax-deferred retirement plan account such as an IRA, ROTH, 401k, 403b, or 457 plan.
  - Same tax rules as for other investments in a qualified tax-sheltered retirement plan.
- **Tax rules for NonQualified annuities are very complex.**
  - Federal and state income tax
  - Estate tax
  - Gift tax

# NQ Annuity Income Tax Rules – The Basics



- Money grows tax-deferred inside the annuity
- No limits or restrictions on contributions
- 10% IRS penalty for withdrawals before age 59 ½
- No Required Minimum Distributions
- Withdrawals and distributions are taxed at ordinary income tax rates
- **Transfer or change of ownership in an annuity contract usually classified by the IRS as a distribution - and is a taxable event.**

# Change in Annuity Ownership – Tax Implications



- **Types of change**
  - Addition or removal of joint owner
  - Transfer to another individual or entity
  - Assignment or pledge as collateral for a loan
- **IRS classifies transfer or change in ownership as taxable event**
- **Exceptions**
  - Transfer between spouses
  - Transfer due to divorce
  - Transfer between individual and their grantor trust

# Change in Annuity Ownership – Tax Consequences



- Income tax on contract earnings at time of transfer
- IRS 10% early withdrawal penalty may apply
- Gift tax rules may apply
- If assign or pledge all or portion of an annuity as collateral for a loan
  - Amount is treated as taxable distribution
  - May be subject to IRS 10% early withdrawal penalty
  - If entire contract is assigned or pledged, any subsequent earnings are treated as partial withdrawals

# NQ Annuity – Income Tax Rules in Accumulation



- Total surrender of annuity, all earnings in the contract are taxed as ordinary income.
- Partial withdrawals from annuity, taxed on last-in-first-out (LIFO) basis.
- May exchange to another product through a 1035 exchange which preserves the tax basis & deferred gains for tax purposes.
- Aggregation rule: **all** annuity contracts issued by the same insurance company to owner are treated as one contract to determine taxable distribution.

# Exceptions to the Aggregation Rule



**Aggregation rule: all annuity contracts issued by the same insurance company to owner are treated as one contract to determine taxable distribution.**

- **Immediate annuities**
- **Annuitized contracts**
- **Distribution required by death of annuity owner**
- **Contracts issued before Oct 1979, and not exchanged with a different annuity**

# NQ Annuity – Income Tax Rules After Annuitization



- Annuity payment = return of principal (tax-free) plus the gain (taxable)
- Fixed annuity
  - Exclusion Ratio determines taxable and non-taxable portions of the payment
  - Ratio = contract principal divided by the contract's future value
  - Future value is based on your life expectancy
- Variable annuity
  - Return of Principal = contract principal divided by number of expected payments (based on your life expectancy)

# Annuitized Fixed NQ Annuity – Example Calculation



- Invest \$100,000 in fixed annuity.
- The annuitized contract pays \$750/month for life starting at age 62.
- Life expectancy of 22.5 years.
- Contract value is \$202,500 (12 X \$750 X 22.5)
- Exclusion ratio is  $\$100,000 / \$202,500$  or 49.4%
- Taxable portion is \$370.50 (49.4% of \$750)
- \$379.50 is the return of principal (tax-free)
- **Taxable portion is recalculated each year.**

# Annuitized Variable NQ Annuity – Example Calculation



- Invest \$100,000 in variable annuity.
- The annuitized contract pays \$750/month for life starting at age 62.
- Life expectancy of 22.5 years.
- 270 payments (12 X 22.5)
- Return of principal is  $\$100,000/270$  or \$370
- The remainder of the payment is taxable as income.
- **Taxable portion is recalculated each year.**

# If Annuitant Dies Without Annuitizing...



- Some annuities allow spouse to continue receiving periodic payments if spouse is the sole beneficiary.
- If beneficiary is grantor trust, IRS requires immediate distribution.
- Otherwise, beneficiary must choose:
  - Immediate distribution
  - Total withdrawal within 5 years after death
  - Payout over life of beneficiary & payout begins within 1 year of annuitant's death.

# What's Your Annuity Information Quotient (IQ) ?



**An annuity is a life insurance-based investment, so all annuities pay a death benefit.**

**True or False?**

# Annuity Fundamentals – Death Benefit



- **Contract not annuitized**
  - Death benefit equal to the account value or principal, whichever is greater.
- **Annuitized contract**
  - Single life payout, no death benefit.
  - Joint life payout, no death benefit. Payout continues until death of survivor.
  - Term certain payout, death benefit paid if money in the annuity contract.
- **“Rider” can be purchased to increase the death benefit.**

# Death Benefit Distribution – Contract Not Annuitized



- If beneficiary is a trust, IRS requires immediate distribution.
- Some contracts allow spouse to become owner of the contract, if spouse is sole beneficiary.
- Otherwise, IRS requires beneficiary to choose:
  - Immediate distribution
  - Total distribution within 5 years of contract owner's death
  - Distribution over the beneficiary's lifetime, beginning within 1 year after contract owner's death
- If a joint life contract, distribution rule is elected upon 1<sup>st</sup> death.

# NQ Annuity – Death Benefit Taxation



- VAs issued before Oct 1979, “step-up” in basis at death & no income tax on earnings.
- Fixed annuities and VAs issued after Oct 1979, no “step-up” in basis and beneficiary pays income tax on contract earnings.
- Unlike a death benefit from life insurance, annuity death benefit is subject to income and estate taxes.
- Transfer or change of ownership may trigger distribution-at-death rules, with tax consequences.

# NQ Annuity – Death Benefit Taxation



- Total value of annuity contract is subject to federal estate tax. State estate tax rules differ by state.
- Contract not annuitized, income tax on earnings in contract.
  - Immediate distribution, income tax on contract earnings.
  - Distribution over 5 years, income tax based on LIFO.
  - Distribution over beneficiary lifetime, income tax based on LIFO.

# Deconstructing an Annuity



- The Chassis
- The Options (AKA “Riders”)
  
- **Chassis and options are selected at time of purchase.**
- Immediate annuity, the payout rate depends on the interest rate at time of purchase.
- Deferred annuity, the payout rate depends on the interest rate at annuitization.

# Deconstructing an Annuity – The Chassis



- **Simple premium vs multiple premiums**
- **Growth during accumulation phase can be:**
  - Fixed or variable
  - Hybrid of fixed & variable (index-linked annuity)
- **Distribution period is term certain, single lifetime, or joint lifetime**
- **Distribution is immediate vs deferred**
- **Distribution amount is fixed or variable**

# Deconstructing an Annuity - Longevity Annuity



- **Advanced life delayed annuity which pays out when you reach a certain age - usually 85**
- **May be variable or fixed annuity**
- **Higher payout than a standard fixed annuity**
- **Money is locked up until payout date.**
- **You don't get anything if you die before the payout date**

# Deconstructing an Annuity – The Chassis



- **Fixed annuity**
  - Money is held in the insurance company's general account. They invest the money in bonds, mainly AAA corporates.
- **Variable annuity**
  - Money is held in subaccounts at mutual fund companies. You select the investments.
- **Hybrid or index-linked annuity**

# Index-Linked Annuity – Factors to Credit Interest



- **Two accounts**
  - Fixed account & an account linked to stock market index
- **Formula for crediting interest**
  - Stock market index
  - Market Participation rate
  - Interest Cap rate
  - Interest rate minimum (floor)

# Index-Linked Annuity - Floor



- **Minimum interest rate credited to a policy**
  - Each year
  - Period of years
  - Term of the contract.
- **For example, if the floor is established at 0%, but the index drops 5%, the account loss is limited to 0%.**
- **Guaranteed Minimum Rate may change, but is never less than zero.**

# Index-Linked Annuity – Example Market Indexes



- S&P 500
- DJIA
- NASDAQ 100
- Euro Stoxx 50
- Blended index

# Index-Linked Annuity – Interest Credit Method



- **Annual Reset**
  - Credited each year based on annual % increase of index
- **Point to Point**
  - Credited once based on % increase of index between start & end of contract period
- **High Water Mark**
  - Credited once based on % increase of index start & “high water mark” of contract period
- **Averaging**
  - Credited based on % increase of index at start and an average

# Index-Linked Annuity – Market Participation



- **Blended Participation rate determines the amount of market gain credited to the account each year.**
- **For example: If the participation rate is 80% and the annual increase of the S&P 500 is 2%, the amount of interest credited be 1.6%.**
- **Market Participation Rate may reset annually**

# Index-Linked Annuity – Interest Rate Cap



- **Blended Maximum interest rate credited in a policy year or over the term of the contract.**
- **For example, if the interest rate is capped at 5%, only 5% would be credited to the contract - even if the formula for participation in the index increased by 8%.**
- **Interest Rate Cap may reset annually.**

# Index-Linked Annuity – Difficult to Evaluate



- **Fixed account & an account linked to stock market index**
  - Some annuities allow once-a-year change in allocation of money to the 2 accounts
  - Some annuities allow once-a-year change in interest crediting formula
- **Formula for crediting interest**
  - Stock market index
  - Market Participation rate
  - Interest Cap rate
  - Interest rate minimum (floor)

# Deconstructing an Annuity- Optional Riders



- Inflation protection
- Additional death benefit
- Bonus rate
  - Extra interest credited in 1<sup>st</sup> year
- Premium Bonus
  - Additional interest credited under certain conditions
- Living benefits
  - Guaranteed accumulation value or income payment

# Annuity Riders– Death Benefit Options



- **Return of Premium**
  - Contract's current market value or the premiums (net of any withdrawals) paid into the contract, whichever is greater.
- **Stepped Up Death Benefit**
  - Full account value at the time of death or the highest account value on any contract anniversary prior to death, whichever is greater.
- **Stepped Up Benefit with Accumulation**
  - Greater of the stepped up death benefit or the total contributions accumulated at a certain annual percentage rate, less any withdrawals.

# Annuity Riders— Premium Bonus



Interest credited to contract is calculated as % of initial premium. Then, the interest credited to the accumulation account "vests in" the contract after a certain number of years.

For example, initial premium of \$10,000 and a 4% premium bonus which vests in years 6-9. Credit of \$400 which earns interest. During years 6-9 the contract "vests in" 25% of the Premium Bonus, plus the earned interest on the bonus each year.

# Variable Annuity (VA) Riders— Living Benefits



- **Guaranteed Minimum Income Benefit**
- **Guaranteed Minimum Accumulation Benefit**
- **Guaranteed Minimum Withdrawal Benefit**
- **Guaranteed Lifetime Withdrawal Benefit**

**And you may only select one Living Benefit rider per variable annuity.**

# VA Riders— Guaranteed Withdrawal Benefit



- **Guaranteed Minimum Withdrawal Benefit**
  - May take annual withdrawals (up to max % ) over a specified time period.
  - Guaranteed withdrawal amount is based on policyholder age at initial withdrawal and the “benefit base”
- **Guaranteed Lifetime Withdrawal Benefit**
  - Lifetime version of the Guaranteed Minimum Withdrawal.
  - Guaranteed payment even after contract value is zero.

# Calculating Guaranteed Withdrawal Benefit



- **Distribution factor**
  - Based on age at time of 1<sup>st</sup> withdrawal.
  - May be level or may increase over time.
  - Applied to the “benefit base” to calculate guaranteed withdrawal.
- **Several methods to determine benefit base**
  - Sum of premium payments.
  - Annuity account value or the max account value on the anniversary date (high water mark), whichever is larger.
  - Bonus may be credited for years with no withdrawals.

# Example: Guaranteed Lifetime Withdrawal Benefit



- Invest \$100,000 at age 62, begin withdrawal of 4.5% of the principal (\$4,500). During Year 1, the stock market rises and the annuity account grows to \$110,000.
- In Year 2, withdrawal of \$4,950 (4.5% of \$110,000) from the account.
- During Year 2, the stock market falls and the account drops to \$90,000. Due to the guarantee, the withdrawal is still \$4,950 in Year 3.
- The withdrawal won't drop below its high-water mark.
- Investment accounts are valued once a year to compute the high-water mark. The account value will rise and fall with the markets, but it also declines due to the annual withdrawals.

# VA Riders— Guaranteed Minimum Accumulation



- **Guaranteed Minimum Accumulation Benefit**
  - After accumulation period, contract guarantees a minimum account value which is either the principal, or is the locked-in gain.
  - Requires the principal investment to be held for a minimum period, with no withdrawals occurring during that period.

# VA Riders— Guaranteed Minimum Income



- **Guaranteed Minimum Income Benefit**
  - After annuitization, guarantees the annuitant will receive minimum payment regardless of market conditions.
  - Minimum amount is pre-determined by assessing the future value of the initial investment.
  - Requires the principal investment to be held for a minimum period, with no withdrawals occurring during that period.

# VA with Living Benefits – Tax Consequences



- Contract has **not** been annuitized, withdrawals are taxed on last-in-first-out (LIFO) basis.
- Initial withdrawals classified as earnings & taxed as ordinary income.
- Aggregation rule: **all** annuity contracts issued by the same insurance company to owner are treated as one contract to determine taxable distribution.

# VA Riders - Who Benefits from GMWB?



- Returns 100% of premium, but must live long enough to recover the premium & overcome cost of the guarantee.
- Maximum annual withdrawal 5-7%. At 5%, need 20 years of withdrawals to recover 100% of premium.
- GMWB chosen when contract issued and can't be changed.
- Cost of GMWB 40 to 75 basis points.
- Withdrawals are taxable in early years of contract.
- Each year, contract holder must request maximum withdrawal.
- Is GMWB compatible with your income needs?

## VA Riders - Who Benefits from GMIB?



- Must live long enough to use annuitization option, at least 10 years.
- Floor rates in GMIBs usually not attractive relative to interest rates.
- GMIB payout period chosen when contract issued and can't be changed.
- Cost of GMWB 50 to 75 basis points.
- Payout rates vary widely between insurance companies
- Is GMIB compatible with your income needs?

# LTC Combo Policies and Policies with LTCi Rider



- **Cash value life insurance with LTC-linked benefit**
  - May use portion of accelerated death benefit to pay LTC expenses (tax-free)
  - Payout reduces death benefit
  - Limit on amount withdrawn for LTC expenses
- **Annuity with LTC-linked benefit**
  - May use up to 120-130% of account value to pay LTC expenses (tax-free)
  - Payout reduces account value

# Considerations in LTC-Linked Benefit Policies



- **Total cost of desired coverage**
  - Cash value life insurance more expensive than term life
  - Stand-alone policies less expensive than linked-benefit policy
- **LTCi policy provides higher coverage per premium dollar compared to linked-benefit policies**
- **Linked-benefit policies often don't provide inflation protection on LTCi coverage**
- **Underwriting is different for linked-benefit policies vs stand-alone life and LTCi policies**
  - May be able to qualify for linked-benefit policy if can't qualify for a stand-alone policy

# Provisions of the 2006 Pension Protection Act (PPA)



## As of January 2010:

- LTC benefits paid from combo policies and policies with LTC riders are tax-free
- Much Broader scope for tax-free 1035 exchange

## Prior to January 2010, 1035 exchange rules:

- Life policy to another life policy, or to an NQ annuity contract.
- NQ deferred annuity to another deferred annuity, or to an immediate annuity contract

# Current 1035 Exchange Rules



- Life policy or NQ annuity to a tax-qualified traditional LTCi policy
- If annuitized, annuity income can pay for LTCi premium
- Life policy or NQ annuity to “hybrid product”
  - Life insurance policy linked to LTC benefits
  - Fixed annuity linked to LTC benefits
  - Insurance products with riders - acceleration riders & extension riders

# Current 1035 Exchange Rules



## Rules Prior to Jan 2010

Life → Life  
Annuity → Annuity  
Life → Annuity  
Annuity to Life is not Allowed

## New 1035 Exchange Rules

1035 New Tax Free Options:

Annuity → LTCi  
Life → LTCi  
QLTCi → LTCi



# ReCap – Identify the Product & Read the Fine Print



- **The Chassis**
- **The Options (riders)**
  
- **Chassis and options are selected at time of purchase**
- **Immediate annuity, the payout rate depends on the interest rate at time of purchase**
- **Deferred annuity, the payout rate depends on the interest rate at annuitization**

# ReCap – The Annuity Chassis



- **Simple premium vs multiple premiums**
- **Growth during accumulation phase can be:**
  - Fixed or variable
  - Hybrid of fixed & variable (index-linked annuity)
- **Distribution period is term certain, single lifetime, or joint lifetime**
- **Distribution is immediate vs deferred (or delayed)**
- **Distribution amount is fixed or variable**

# ReCap - Annuity Riders



- Inflation protection
- Additional death benefit
- Bonus rate
- Premium Bonus
- Living benefits (guaranteed income or accumulation)
- LTC-linked benefits

# ReCap – Tax Rules & Consequences



- **Tax-Qualified vs NonQualified (NQ) annuities**
- **Annuity inside a tax-qualified retirement plan, distributions are taxed according to tax rules for the retirement plan.**
- **Tax rules for NonQualified annuities are very complex.**
  - **Federal and state income tax**
  - **Estate tax**
  - **Gift tax**
  - **Change of ownership rules**
  - **Distribution -on-death rules**

# Putting It All Together - Why Would Someone Buy?



- Immediate annuity
- Deferred annuity
- Fixed annuity
- Variable annuity
- Index-linked annuity
- Income guaranteed annuity
- Longevity annuity
- Inflation protected annuity
- Policies with LTCi-linked benefits

Thank You for Attending



**Deciphering Annuities  
and Other Insurance-Based Investments**

Phoenix AAI Chapter Meeting  
January 14, 2012

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