Phoenix AAII Chapter Meeting

Deciphering Annuities
and Other Insurance-Based Investments

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- Independent advisor providing wealth and risk management solutions for individuals and business owners.
- PhD, MA, and BA in Science
- Prior career: 16 years business & financial analysis
- 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.

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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

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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

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Some Recent AAII 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)

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What's Your Annuity Information Quotient (IQ) ?

Annuities can protect you from stock market losses

True or False?

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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.

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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?

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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 1stfirst year, gradually decreasing over the next 7-10 years.
  - Early withdrawal often voids or reduces annuity guarantees.
  - Withdrawals before age 59 ½ trigger IRS penalty of 10%.
- Once annuitized, an annuity contract is locked into a set payout schedule.

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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.

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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”.

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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.

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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.

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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?

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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.

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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

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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?

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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

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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.

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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.

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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

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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://ww.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

    http://ww.ssa.gov/OACT/STATS/table4c6.html
- $100,000 immediate annuity at 3%, annual payout
  - 65-year-old man about $7,500
  - 65-year-old woman about $6,800.

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

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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

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

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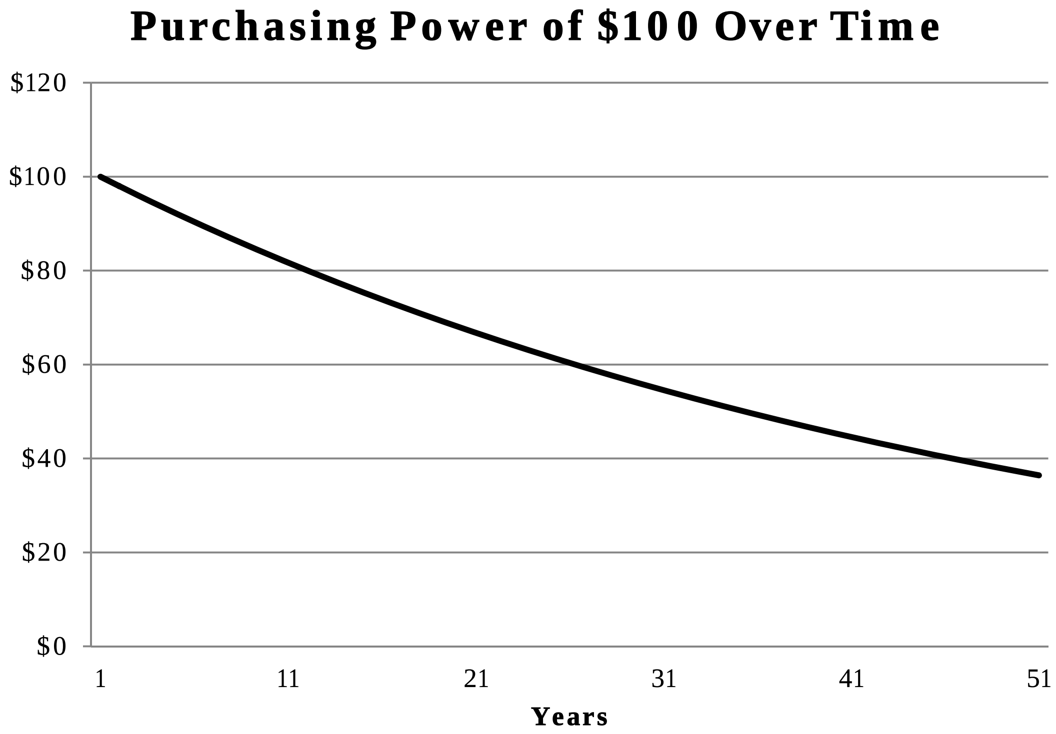
Concepts – Inflation, the Silent Killer



Money is worth more today than tomorrow

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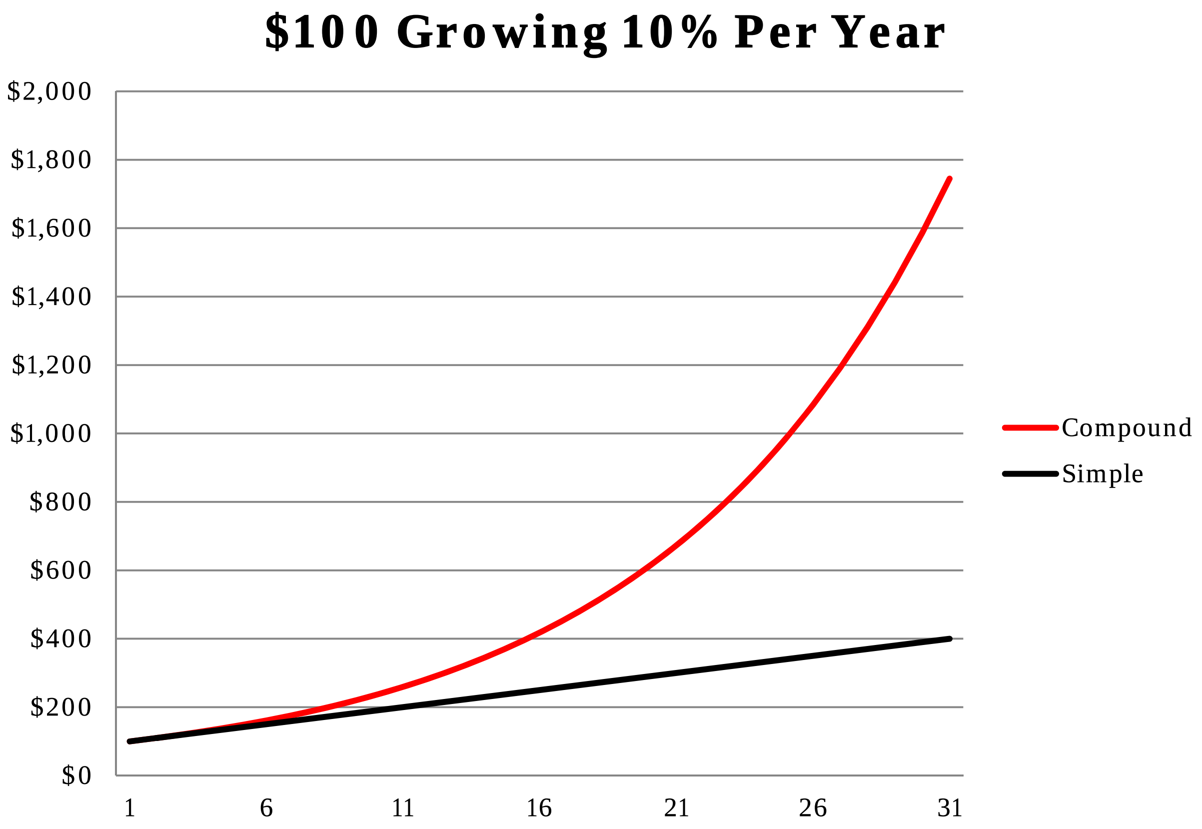
Concepts – Power of Compounding



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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.

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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

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What's Your Annuity Information Quotient (IQ) ?

Most immediate annuity payments keep up with inflation.

True or False?

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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).

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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

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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

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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

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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

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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.**

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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

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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

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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.

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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

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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.**

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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.**

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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?

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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.

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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 1st death.

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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.

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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.

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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.

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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

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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

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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

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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
- NASDQ 100
- Euro Stoxx 50
- Blended index

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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

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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

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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.

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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 1st year
- Premium Bonus
  - Additional interest credited under certain conditions
- Living benefits
  - Guaranteed accumulation value or income payment

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Annuity Riders– Death Benefit Options

- Return of Premium
  - Contract's current market value or the premiums (net of any withdrawals) paid into the contract, which ever 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.

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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.

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Calculating Guaranteed Withdrawal Benefit

- Distribution factor
  - Based on age at time of 1st 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.

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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.

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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.

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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.

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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?

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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?

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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

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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

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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

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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

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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

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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

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ReCap - Annuity Riders

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

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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

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Thank You for Attending

Deciphering Annuities
and Other Insurance-Based Investments

Phoenix AAII Chapter Meeting

January 14, 2012

Presented by Joyce Morningstar, PhD

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