Chapter 17

Annuities

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SYNOPSIS

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Variable annuities have become a part of the retirement and investment plans of many Americans. This chapter provides a general description of annuities with special focus on variable annuities, including what they are, how they work, and the charges you will pay. Before buying any variable annuity, however, you should find out about the particular annuity you are considering. Request a prospectus from the insurance company or from your financial professional, and read it carefully. The prospectus contains important information about the annuity contract, including fees and charges, investment options, death benefits, and annuity payout options. Additionally, you should compare the benefits and costs of the annuity to other variable annuities and to other types of investments, such as mutual funds. Moreover, be prepared to ask your insurance agent, broker, financial planner, or other financial professional lots of questions about whether a variable annuity is right for you.

17-1. What Is an Annuity?

An annuity is a contract between you and an insurance company under which you make a lump-sum payment or series of payments. In return, the insurer agrees to make periodic payments to you beginning immediately or at some future date. Annuities typically offer tax-deferred growth of earnings and may include a death benefit that will pay your beneficiary a guaranteed minimum amount, such as your total purchase payments.

17-2. Types of Annuities

There are generally two types of annuities: fixed and variable. In a **fixed annuity**, the insurance company guarantees that you will earn a minimum rate of interest specified in the annuity contract during the time that your account is growing. The insurance company also guarantees that the periodic payments will be a guaranteed amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

In a **variable annuity**, by contrast, you can choose to invest your purchase payments from among a range of different investment options, typically mutual funds. You may direct allocations of your money into separate accounts. The rate of return on your purchase payments, and the amount of the periodic payments you will eventually receive, will vary depending on the performance of the investment options you have selected.

Variable annuities differ from mutual funds in several important ways, such as:

- Variable annuities let you receive periodic payments for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.
- Variable annuities have a death benefit. If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount — typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.

- Variable annuities are tax deferred. This means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals.

An **equity-indexed annuity** is a special type of annuity. During the accumulation period — when you make either a lump-sum payment or a series of payments — the insurance company credits you with a return that is based on changes in an equity index, such as the S&P 500 Composite Stock Price Index. The insurance company typically guarantees a minimum return, but guaranteed minimum return rates vary. After the accumulation period, the insurance company will make periodic payments to you under the terms of your contract, unless you choose to receive your contract value in a lump sum.

17-3. Regulation of Annuities

Fixed annuities are not securities and are not regulated by the Securities and Exchange Commission (SEC). Check with the Colorado Division of Insurance regarding regulation of fixed annuities (see section 17-6, "Resources," for more information). Variable annuities are securities regulated by the SEC. Equity-indexed annuities combine features of traditional insurance products (guaranteed minimum return) and traditional securities (return linked to equity markets). Depending on the mix of features, an equity-indexed annuity may or may not be a security. Currently, the typical equity-indexed annuity is registered with the state insurance commissions, and is not registered with the SEC.

17-4. How Variable Annuities Work

A variable annuity has two phases: an **accumulation phase** and a **payout phase**. During the **accumulation phase**, you make purchase payments, which you can allocate to a number of investment options. For example, you could designate 40 percent of your purchase payments to a bond fund, 40 percent to a U.S. stock fund, and 20 percent to an international stock fund. The money you have allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, variable annuities often allow you to allocate part of your purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (*e.g.*, 3 percent per year).

During the accumulation phase, you can typically transfer your money from one investment option to another without paying tax on your investment income and gains, although you may be charged by the insurance company for transfers. If you withdraw money from your account during the early years of the accumulation phase, however, you may have to pay "surrender charges," which are discussed below. In addition, you may have to pay a 10 percent federal tax penalty if you withdraw money before the age of 59½.

> ***Tip:*** Your most important source of information about a variable annuity's investment options is the prospectus. Request the prospectuses for the mutual fund investment options. Read them carefully before you allocate your purchase payments among the investment options offered. You should consider a variety of factors with respect to each fund option, including the fund's investment objectives and policies, management fees and other expenses that the fund charges, the risks and volatility of the fund, and whether the fund contributes to the diversification of your overall investment portfolio. The SEC's online publication, *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, provides information about these factors. Another SEC online publication, *Invest Wisely: An Introduction to Mutual Funds*, provides general information about the types of mutual funds and the expenses they charge. (See section 17-6, "Resources," for a link to the SEC's website.)

At the beginning of the **payout phase**, you may receive your purchase payments plus investment income and gains (if any) as a lump-sum payment, or you may choose to receive them as a stream of payments at regular intervals (generally monthly). The choice regarding how you receive payments is called a **settlement option.** Moreover, the **maturity date** is the latest date on which you can begin receiving payments from your annuity under any of the settlement options available to you. The date shown on the **specifications page** of your contract is automatically set as the date when you *must* begin receiving payments from your contract.

If you choose to receive a stream of payments, you may have a number of choices of how long the payments will last. As mentioned above, under most annuity contracts, you can choose to have your annuity payments last for a period that you set (such as 20 years) or for an indefinite period (such as your lifetime or the lifetime of you and your spouse or other beneficiary). During the payout phase, your annuity contract may permit you to choose between receiving payments that are fixed in amount or payments that vary based on the performance of mutual fund investment options.

The amount of each periodic payment will depend, in part, on the time period that you select for receiving payments. Be aware that some annuities do not allow you to withdraw money from your account once you have started receiving regular annuity payments.

In addition, some annuity contracts are structured as **immediate annuities**, which means that there is no accumulation phase and you will start receiving annuity payments right after you purchase the annuity.

> ***Caution:*** Withdrawals prior to age 59½ may be subject to 10 percent federal tax penalties.

The Death Benefit and Other Features

A common feature of variable annuities is the **death benefit**. If you die, a person you select as a beneficiary (such as your spouse or child) will receive the greater of (1) all the money in your account, or (2) some guaranteed minimum (such as all purchase payments minus prior withdrawals).

Some variable annuities allow you to choose a "stepped-up" death benefit. Under this feature, your guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be your account value as of a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to "lock in" your investment performance and prevent a later decline in the value of your account from eroding the amount that you expect to leave to your heirs. This feature carries a charge, however, that will reduce your account value.

Variable annuities sometimes offer other optional features, which also have extra charges. One common feature, the **guaranteed minimum income benefit**, guarantees a particular minimum level of annuity payments, even if you do not have enough money in your account (perhaps because of investment losses) to support that level of payments. Other features may include **long-term care insurance**, which pays for home health care or nursing home care if you become seriously ill.

Caution: You will pay for each benefit provided by your variable annuity. Be sure you understand the charges. Carefully consider whether you need the benefit. If you do, consider whether you can buy the benefit more cheaply as part of the variable annuity or separately (*e.g.*, through a long-term care insurance policy).

Tip: You may want to consider the financial strength of the insurance company that sponsors any variable annuity you are considering buying. This can affect the company's ability to pay any benefits that are greater than the value of your account in mutual fund investment options, such as a death benefit, guaranteed minimum income benefit, long-term care benefit, or amounts you have allocated to a fixed account investment option.

Variable Annuity Charges

You will pay several charges when you invest in a variable annuity. Be sure you understand all the charges before you invest. **These charges will reduce the value of your account and the return on your investment.** Often, they will include the following:

- **Surrender charges.** A **surrender charge** is a type of sales charge you must pay if you sell or withdraw money from a variable annuity during the "surrender period," which is a set period of time that typically lasts six to eight years, but sometimes 10 years or longer, after you purchase the annuity. Surrender charges will reduce the value of, and the return on, your investment. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the "surrender period." For example, a 7 percent charge might apply in the first year after a purchase payment, 6 percent in the second year, 5 percent in the third year, and so on until the eighth year, when the surrender charge no longer applies. Often, contracts will allow you to withdraw part of your account value each year — 10 or 15 percent of your account value, for example — without paying a surrender charge.

- **Mortality and expense risk charge.** This charge is equal to a certain percentage of your account value, typically around 1.25 percent per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to your financial professional for selling the variable annuity to you.
- **Share classes.** A variable annuity may offer different share "classes" with different charges (including mortality and expense fees) and different surrender charge periods. For example, "L class" shares may have a shorter surrender charge period, but may have higher ongoing fees, while "B class" shares may have a longer surrender charge period and lower ongoing fees. Consider how long you expect to own the variable annuity and your need to access funds when you think of any tradeoff between the length of the surrender charge period and the level of ongoing fees. Also, because fees are paid from the amount you invest, they can reduce your potential investment return.
- **Administrative fees.** The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of your account value (typically around 0.15 percent per year).
- **Underlying fund expenses.** You will also indirectly pay the fees and expenses imposed by the mutual funds that are the underlying investment options for your variable annuity.
- **Fees and charges for other features.** Special features offered by some variable annuities, such as a **stepped-up death benefit**, a **guaranteed minimum income benefit**, or **long-term care insurance**, often carry additional fees and charges.
- **Initial sales loads**, or fees for **transferring** part of your account from one investment option to another, may also apply.

Tip: *You should ask your financial professional to explain to you all charges that may apply. You can also find a description of the charges in the prospectus for any variable annuity that you are considering.*

Tax-Free "1035" Exchanges

Section 1035 of the U.S. tax code allows you to exchange an existing variable annuity contract for a new annuity contract without paying any tax on the income and investment gains in your current variable annuity account. These tax-free exchanges, known as 1035 exchanges, can be useful if another annuity has features that you prefer, such as a larger death benefit, different annuity payout options, or a wider selection of investment choices.

You may, however, be required to pay surrender charges on the old annuity if you are still in the surrender charge period. In addition, a new surrender charge period generally begins when you exchange into the new annuity. This means that, for a significant number of years (as many as 10 years), you typically will have to pay a surrender charge (which can be as high as 9 percent of your purchase payments) if you withdraw funds from the new annuity. Further, the new annuity may have higher annual fees and charges than the old annuity, which will reduce your returns.

> **Caution:** *If you are thinking about a 1035 exchange, you should compare both annuities carefully. Unless you plan to hold the new annuity for a significant amount of time, you may be better off keeping the old annuity because the new annuity typically will impose a new surrender charge period. (Remember — exchanging your original variable annuity contract for a new annuity contract generally is considered a withdrawal.) Also, if you decide to do a 1035 exchange, you should talk to your financial professional or tax adviser to make sure the exchange will be tax free. If you surrender the old annuity for cash and then buy a new annuity, you will have to pay tax on the surrender.*

Other Tax Considerations

Other investment vehicles, such as IRAs and employer-sponsored 401(k) plans, also may provide you with tax-deferred growth and other tax advantages. For most investors, it will be advantageous to make the maximum allowable contributions to IRAs and 401(k) plans before investing in a variable annuity.

In addition, if you are investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), you will get *no additional tax advantage* from the variable annuity. Under these circumstances, consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection. The tax rules that apply to variable annuities can be complicated; before investing, you may want to consult a tax adviser about the tax consequences to you of investing in a variable annuity.

Bonus Credits

Some insurance companies are now offering variable annuity contracts with "bonus credit" features. These contracts promise to add a bonus to your contract value based on a specified percentage (typically ranging from 1 to 5 percent) of purchase payments. Frequently, insurers will charge you for bonus credits in one or more of the following ways:

- **Higher surrender charges.** Surrender charges may be higher for a variable annuity that pays you a bonus credit than for a similar contract with no bonus credit.
- **Longer surrender periods.** Your purchase payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit.
- **Higher mortality and expense risk charges and other charges.** Higher annual mortality and expense risk charges may be deducted for a variable annuity that

pays you a bonus credit. Although the difference may seem small, over time it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.

Before purchasing a variable annuity with a bonus credit, ask yourself — and the financial professional who is trying to sell you the contract — whether the bonus is worth more to you than any increased charges you will pay for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long you hold your annuity contract, and the return on the underlying investments. You also need to consider the other features of the annuity to determine whether it is a good investment for you.

Caution: Variable annuities with bonus credits may carry a downside, however: higher expenses that can outweigh the benefit of the bonus credit offered. You should also note that a bonus may only apply to your initial premium payment, or to premium payments you make within the first year of the annuity contract. Further, under some annuity contracts, the insurer will take back all bonus payments made to you within the prior year or some other specified period if you make a withdrawal, if a death benefit is paid to your beneficiaries upon your death, or in other circumstances.

Tip: Take a hard look at bonus credits. In some cases, the "bonus" may not be in your best interest.

Remember: Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if you withdraw your money early. Variable annuities also involve investment risks, just as mutual funds do.

17-5. Questions to Ask Before Investing

Questions to Ask When Purchasing Variable Annuities

Variable annuities combine features of insurance and securities investments. They can be an important part of your retirement and investment plans, but it is important to make sure they are right for you. **Before you purchase an annuity, request a prospectus from the insurance company or from your financial professional, and read it carefully.** The prospectus contains important information about the annuity contract, including fees and charges, investment options, death benefits, and annuity payout options. You should compare the benefits and costs of the annuity to other variable annuities and to other types of investments, such as mutual funds.

Recently, the SEC issued a report on how these products are sold. Based on the problems we've seen, here are some important questions we recommend that you ask before purchasing a variable product.

- Will you use the variable annuity primarily to save for retirement or a similar long-term goal?
- Might I need this money in the next few years? Variable products are long-term investment vehicles. They aren't appropriate if you'll need your money in the short term because substantial taxes and insurance company charges may apply if you withdraw your money early.
- Am I willing to take the risk that my account value may decrease if the underlying mutual fund investment options perform badly?
- Do I understand the features of the variable annuity? Do I understand all of the fees and expenses that the variable annuity charges?
- If a variable annuity offers a bonus credit, will the bonus outweigh any higher fees and charges that the product may charge?
- Are there features of the variable annuity, such as long-term care insurance, that I could purchase more cheaply separately?
- Do I have enough money right now to purchase this product? Because variable products are long-term investments, it can be dangerous to your financial health to mortgage your home in order to purchase a variable annuity. If a salesperson pressures you to do so, call the SEC or another agency listed in section 17-6, "Resources."
- Am I being urged to purchase a variable annuity or variable insurance in my IRA, 401(k), or other retirement account? One key benefit to purchasing variable products is the fact that earnings on the invested money accumulate tax deferred. But these tax benefits are of no value if you're purchasing the product in your IRA, 401(k), or other retirement account because those accounts are already tax-advantaged. Make sure that the features you're buying are worth the money you're paying.
- Does the firm recommend this product to all its customers? Everyone has different investment objectives. Variable products are not "one size fits all." Be careful if a salesperson recommends one product to all customers. That may mean the product isn't right for you.
- What will I lose if I exchange this product? If a salesperson is urging you to exchange your variable product for a new contract, you'll need to compare both products carefully, because:
    - The guaranteed death benefit of the new product may be less than the old;
    - You may have to pay a "surrender charge" to get out of the old product;
    - The new product may impose higher annual fees and a new surrender charge; and
    - The new product may impose a new surrender charge period.
- Have you consulted with a tax advisor and considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on your tax status in retirement?

Remember: Variable annuity contracts typically have a "free look" period of 10 or more days, during which you can terminate the contract without paying any surrender charges and get back your purchase payments (which may be adjusted to reflect charges and the performance of your investment). You can continue to ask questions in this period to make sure you understand your variable annuity before the "free look" period ends.

Questions to Ask the People Who Sell Investments or Provide Investment Advice

Financial professionals who sell variable annuities have a duty to advise you as to whether the product they are trying to sell is suitable to your particular investment needs. Don't be afraid to ask them questions, and write down their answers, so there won't be any confusion later as to what was said.

Tip: Check the background of your financial professional: you can verify your broker's disciplinary history by checking the Central Registration Depository (CRD) either through the Colorado Division of Securities or the Financial Industry Regulation Authority (FINRA). You can also find out about investment advisers and whether they are properly registered by reading their registration forms, called the "Form ADV." You can view an adviser's most recent Form ADV online by visiting the SEC's website. (See section 17-6, "Resources," for more information.)

- ▶ Are you registered with our state securities regulator? Have you ever been disciplined by the SEC, a state regulator, or other organization (such as FINRA or one of the stock exchanges)?
- ▶ What training and experience do you have? How long have you been in the business? What other firms have you been registered with? What is the status of those firms today?
- ▶ Have you personally been involved in any arbitration cases? What happened?
- ▶ How long has your firm been in business? How many arbitration awards have been filed against your firm?
- ▶ What is your investment philosophy?
- ▶ Describe your typical client. Can you provide me with some names and telephone numbers of your long-term clients?
- ▶ How do you get paid? By commission? Amount of assets you manage? Another method? Do I have any choices on how to pay you?
- ▶ Do you make more if I buy this annuity (or stock, or bond, or mutual fund) rather than another? If you weren't making extra money, would your recommendation be the same?
- ▶ Are you participating in a sales contest? Is this purchase really in my best interest, or are you trying to win a prize?

- ▶ You've told me what it costs me to buy this stock (or bond, or mutual fund); how much will I receive if I sell it today?
- ▶ If your financial professional changes firms, ask if he or she was paid to change firms. Do you get anything for bringing me along?

17-6. Resources

U.S. Securities and Exchange Commission
Office of Investor Education and Advocacy
100 F St., NE
Washington, D.C. 20549
(800) SEC-0330
www.sec.gov

Denver Regional Office
1961 Stout St., Ste. 1700
Denver, CO 80294
(303) 844-1000

Colorado Division of Insurance
1560 Broadway, Ste. 850
Denver, CO 80202
(303) 894-7499 (metro-area)
(800) 930-3745 (statewide)
www.dora.colorado.gov/insurance

Colorado Division of Securities
1560 Broadway, Ste. 900
Denver, CO 80202
(303) 894-2320
www.dora.colorado.gov; click on "Divisions," then "Division of Securities"

Colorado Attorney General/AARP ElderWatch Hotline
(800) 222-4444

Local District Attorneys Offices

Metro Area District Attorney Offices or Fraud Hotlines:
Adams and Broomfield counties: (303) 659-7720
Arapahoe, Douglas, Lincoln, and Elbert counties: (720) 874-8500
Boulder County: (303) 441-3700
Denver County: (720) 913-9179 (Fraud hotline)
Jefferson and Gilpin counties: (303) 271-6800

Financial Industry Regulatory Authority (FINRA)

The largest non-governmental regulator for all securities firms, including sellers of variable annuities, doing business in the United States. As of June 2007, FINRA is the combination of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) regulatory bodies. Call for a free Central Registration Depository (CRD) broker check at (800) 289-9999.

www.finra.org
www.SaveAndInvest.org/index.htm