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MONTANA STATE UNIVERSITY EXTENSION

MontGuide

Annuities

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This MontGuide describes types of annuities, contract charges, settlement options, tax consequences, shopping tips, and protections for investors provided by Montana law.

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RETIREMENT…WHAT DOES IT MEAN TO YOU?

Time to do what you want… when you want to? More time for family and friends? Travel to places on your "bucket-list?" New hobbies and pursuits? Perhaps a vacation home? Regardless of how you visualize your "golden years," achieving your retirement goals won't happen overnight. You have to make a plan and revise it periodically based on your changing situation and/or what is happening in the economy.

Many people achieve success by depositing money in a number of different retirement savings "building blocks" such as Individual Retirement Accounts (IRAs), Keoghs, and company pension plans (401k, 403b, SEPs, SIMPLES). After they have taken advantage of these "building blocks" to provide income to supplement Social Security, some have also chosen to purchase an annuity outright or utilize their pension funds to purchase one.

What is an annuity?

Basically, an *annuity* is a contract between an individual and an insurance company or another person. The individual pays a premium, and in return, the other party agrees to make payments to the individual during that person's lifetime and/or to the individual's survivors.

Basic types of annuities

The most common type of annuity is termed a **commercial annuity**. It is typically issued by an insurance company for cash. An individual pays a sum of money to the company (the insurer) that promises to make periodic payments for the remainder of the annuitant's life (the purchaser). Annuitants may elect to have the payments continue for survivors for a higher premium. Or, for the same premium, annuitants may choose a reduced benefit so survivor benefits can be provided.

A private annuity differs from a commercial annuity in two respects: 1) property other than cash is used to acquire the annuity, and 2) the promise to make the payments is made by an individual rather than an insurance company. Payments from a private annuity are not insured by the Montana Life and Health Insurance Guaranty Association.

A **private annuity** could be used by parents who want to transfer a farm, ranch or other business to a younger family member in exchange for a guaranteed income for life. The transferred asset receives a new income tax basis for the purchaser equal to the present value of the annuity payments to be made.

While a private annuity usually ceases upon death of the annuitant, there are some drawbacks and tax ramifications. If the parent(s) live longer than their life expectancies, the younger family member will have paid out more than the value of the asset he/she acquired. The parents' future income flow is secured only by the annuity agreement and not by a mortgage on the property. Annuity payments made to the parents are not like mortgage payments whereby the interest portion is tax deductible.

If the younger family member dies before the parent, his estate is legally obligated to continue to pay the annuity until the parent dies. Competent legal and accounting advice is recommended for Montanans who want to set up a private annuity to minimize potential adverse legal and tax consequences for all parties involved.

A **charitable gift annuity** is a contract between an individual and a charity (instead of an insurance company). An individual or married couple gives money or property to a charity and receives an income tax deduction at the time of the gift (donation) equal to the portion anticipated to go to charity when the annuitant(s) dies. The charity agrees to pay an annuity to one or more individuals and/or other annuitant(s) for his/her/their lives. Unless the charity commercially reinsures the annuity, it is backed only by the charity's total assets. There is no guarantee of payment if the charity goes bankrupt, which is why Montana law only permits charities above a certain threshold of financial strength to issue gift annuities.

Individuals considering a charitable gift annuity should have the contract examined by an attorney to make sure it meets their retirement and estate planning goals. This planned gift instrument is generally preferred by older individuals who want the security of a fixed payment, and want the tax benefits now, but do not want to benefit the charity until they pass away. A gift annuity is a also a planned gift which will entitle the purchaser to the 40 percent Montana Endowment Tax Credit for the charitable gift portion of the transaction if the other requirements of the credit are met.

Categorization of annuities

Annuities are typically categorized by: timing of income payments, purchase payments, and investment performance.

Timing of payments. An immediate annuity starts payments to an individual within 12 months of the annuity purchase date. Immediate annuities are generally purchased by people who have reached retirement age. A deferred annuity starts payments more than 12 months after the purchase date as stated in the contract or policy. Deferred annuities are often purchased by people who are saving money towards retirement. A longevity annuity pays an income for life, but only if the annuitant lives to a certain age. For example, a person could pay an insurance company a lump-sum of money at age 65 for an annuity in return for a monthly income starting at age 85.

Purchase payments. An annuity can be purchased with a single sum or with a series of payments. One purchased with a single sum is called a single payment or single premium annuity. Immediate annuities are always purchased with a single sum. An annuity purchased with a series of payments is called a periodic payment, multiple premiums or a flexible premium annuity. Deferred annuities are generally purchased with a series of payments.

Investment performance. There are three types of annuities categorized by investment performance: fixed, equity-indexed, and variable.

A *fixed* or *guaranteed annuity* provides an interest rate guaranteed by the insurance company. The amount of income paid to the annuitant is generally set when the payments begin and does not change. An interest rate is locked in for an initial period, typically one to three years. When the period ends, the insurance company designates a new rate of return for the next time period.

Most fixed annuities have a minimum guaranteed rate the insurance company will pay regardless of economic conditions. However, the guarantee is only as good as the company. There is no guarantee that a fixed annuity will pay more than the rate of inflation. Because the payment is fixed, it is not likely to keep pace with inflation especially over a long period of time. A fixed annuity does not protect an annuitant's assets from lawsuits or seizures.

An *equity-indexed annuity* is a variation of a fixed annuity. The interest rate is based on one of the published stock market indexes, such as Standard & Poor's 500 or Vanguard 500. The value of any index varies from day-to-day and is not predictable. The annuity promises to pay a minimum interest rate, but the rate of return could be higher if the stock market index increases in value. An equity-indexed annuity does not protect an annuitant's assets from lawsuits or seizures.

The National Association of Insurance Commissioners and Financial Industry Regulatory Authority, Inc. (FINRA) provide two publications for those considering the purchase of equity-indexed annuities. *Buyers Guide to Equity-Indexed Annuities* explains indexing methods, terms, participation rates, and cap rates (www.insurance.Illinois.gov/life_annuities/equityindex.asp). *Equity-Indexed Annuities: A Complex Choice for Those Who Want to Learn More About Equity-Index Annuities* explains: index methods annual reset, high water mark and point-to-point (www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p010614).

Variable annuities are securities registered with the Securities and Exchange Commission. The purchaser, rather than the insurance company, decides how to allocate the annuity premium among possible investments. Typically an annuitant will select a family of mutual funds that invest in stocks, bonds, money market instruments, or a combination of the three. A variable annuity does not protect an annuitant's assets from lawsuits or seizures.

Variable annuities offer the potential to earn more than a fixed annuity, but the value of the annuity can also decrease with changes in the mutual funds' values. The guaranteed minimum return is typically 87.5 percent of the premium paid with 1 to 3 percent interest.

If the value of the underlying mutual funds and the rate of return are adjusted with inflation, a variable rate annuity may provide some protection against inflation.

There is no guarantee that variable annuities will keep pace with inflation.

Some variable annuities have a death benefit. If the annuitant dies before the insurer has started making payments, the beneficiary receives a specified amount – typically the amount of the annuitant's purchase payments.

When money is withdrawn from a variable annuity, the annuitant is taxed on the earnings at an ordinary income tax rate rather than a lower capital gains rate that would be paid on a direct investment. In general, the benefits of tax-deferral outweigh the costs of a variable annuity only if it is held as a long-term investment to meet retirement and other long-range goals.

FINRA provides two publications about variable annuities:

Variable Annuities: Beyond the Hard Sell (www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p005976)

and, *Should You Exchange Your Variable Annuity?* (www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p006045)

The Securities and Exchange Commission provides further information in *Variable Annuities: What You Should Know* (www.sec.gov/investory/seniors.shtml)

Charges for Annuities

There are a variety of charges that should be considered when purchasing an annuity: surrender charges, annual charges, fees and expenses, and charges for special features.

Surrender charge. This is the amount charged if funds are withdrawn before a certain period of time. The surrender charge is typically a percentage of the amount withdrawn during the first 7 to 15 years of the annuity contract. The charge declines gradually over a period of several years, known as the surrender period. For example, a 10 percent charge could apply in the first year after a purchase of the annuity, and decline by one percent per year until it reaches zero percent 10 years later. Some contracts allow an annuitant to withdraw a part of the account value each year, for example 10 percent or 15 percent, without paying surrender charges.

Annual charge. This is the amount charged annually for the cost of administering the annuity contract. Annual charges may range from $25 to $40 depending on amount in the annuity. Some companies charge a percentage of the account value (typically in the range of 0.15 percent per year).

Fees and expenses. The interest rate quoted for a fixed annuity is the amount to be paid to the annuitant after the insurance company deducts fees and expenses from the rate earned on the underlying investments. The expenses for a variable annuity are frequently called mortality and expense risk charges. The fees may range annually from 1 to 2 percent of the amount of assets in the annuity. There are also specific mutual fund fees for variable annuity contracts that include maintenance and management investment advisory fees. The management advisory fees are calculated as a percentage of the fund assets. Be sure to ask if the historical rates of returns quoted are after expenses.

Other Charges. Special features offered by some variable annuities (for example death benefit, bonus credit, long-term care insurance) carry additional fees. Other annuities have fees for initial sales load (similar to a commission investors pay when they purchase any type of security from a broker) or fees for transferring part of the account from one investment option to another. Annual fees can reach 2 percent or more of the annuity's value. The prospectus of a variable annuity describes fees and expenses. The potential purchaser should insist that all fees be explained by the sales representative.

Methods of paying benefits

There are 5 methods of paying benefits provided in a typical annuity: (1) straight life or lifetime-only; (2) Installment-refund annuity; (3) cash-refund annuity; (4) life-and-period-certain annuity; and (5) joint-and-survivor annuity.

A *straight-life* or *lifetime-only annuity* pays the annuitant until death, regardless of whether he or she lives to age 100 or dies shortly after signing the contract. This type of annuity is usually used by people who need larger monthly incomes, who do not have dependents, or who plan to provide financial resources for their dependents in another way.

An *installment-refund annuity* provides lifetime income to the annuitant, and if the annuitant dies, pays the remainder of the original investment to the beneficiary in monthly installments. This type is often used by people who want to provide a lifetime income for a beneficiary, rather than a lump sum payment.

A *cash-refund annuity* works like an installment-refund except that the survivor receives the balance of the premiums the annuitant paid to the company in a lump sum. This option is often used by an annuitant who believes a beneficiary is capable of managing a lump sum of money.

A *life-and-period-certain annuity* pays the annuitant and a beneficiary for a specified number of years with a typical amount of time of 10, 15, or 20 years. If an annuitant purchases a 15-year life-and-period-certain annuity and dies after 8 years, his/her beneficiary will receive monthly payments for the remaining 7 years of the contract. This type is used by an annuitant who wants money to last for a certain number of years and wants his/her beneficiaries receive the balance as an inheritance.

A *joint-and-survivor annuity* pays until both the annuitant and his or her beneficiary are deceased. The amount of the monthly check is based on the ages of the annuitant and the beneficiary. Joint-and-survivor contracts can pay 100 percent, 75 percent, 67 percent or 50 percent of the monthly benefit to a survivor. This type is used to provide a lifetime income to a survivor to supplement his/her other sources of income.

Tax Consequences: Income, Estate and Inheritance

Income. An annuitant is not taxed annually on the interest earnings that are held in an annuity. Federal and state income tax on interest earning annuities is deferred until the annuitant starts receiving monthly payments, then the earnings are taxable.

Tax-deferred Contributions. Annuities that meet specific legal requirements can offer the additional tax advantage of pre-tax contributions, typically termed tax-deferred annuities. Types of employer plans permitting pre-tax contributions include: 401(a), 401(k), 403(a), 403(b), and 402(b) plans; Simplified Employee Pension Plans; and 457 Deferred Compensations Plans.

The major advantage of a tax-deferred annuity is that neither contributions nor interest earned are subject to federal or state income taxation until withdrawn. This effectively lowers gross income of the employee and reduces annual state and federal income tax liabilities similar to traditional (ordinary) Individual Retirement Accounts (IRAs).

When an employee withdraws funds from a tax-deferred annuity, the amount is subject to state and federal income taxation (See Chart 1). There may be an additional 10 percent federal penalty for amounts withdrawn before age 59½ unless the annuitant becomes totally and permanently disabled, takes out the money in a series of substantially equal periodic payments for the annuitant's life or the joint lives of the annuitant and his/her designated beneficiary, or dies.

Tax-Free 1035 Exchange. Annuitants can exchange an existing variable annuity contract for a new contract without paying any tax on the income and investment gains. A 1035 exchange can be useful if another annuity has better features, such as a larger death benefit, different annuity payout, or a wider selection of investment choices. The new annuity will impose a new surrender charge period that generally begins when the exchange is made.

Generally an annuitant should exchange an annuity only after asking these questions and comparing benefits with the existing policy:

- What is the total cost of this exchange?
- What is the new surrender period?
- What new features are being offered?
- Do I need or want these features?
- Could a feature such as long-term care insurance be purchased separately at less cost?
- Are additional features worth the increased cost?
- What is the length of the free-look period?

Investors should not sign any form to agree to exchange an annuity until their options are carefully studied, their questions are answered, and they are satisfied the exchange is better than their current contracts.

CHART 1. A comparison of the tax impact of a deductible and non-tax deductible annuity

Tax Deferred Annuity	Non-Tax Deferred Annuity
Salary = $100,000	Salary = $100,000
Annuity Premiums = $10,000	Annuity Premiums = $10,000
Taxable Income = $90,000	Taxable Income = $100,000
Federal Income Tax Rate = 25%	Federal Income Tax Rate = 25%
Federal Income Tax = $22,500	Federal Income Tax = $25,000
Montana Income Tax Rate = 6.9%	Montana Income Tax Rate = 6.9%
Montana Income Tax: $6,210 - $522* = $5,688	Montana Income Tax: $6,900 - $522* = $6,378
Spendable Income = $61,812	Spendable Income = $58,622

*Amount subtracted changes annually. $522 is for the 2012 tax year.

FINRA provides a publication with more information about exchanging a variable annuity, *Should You Exchange Your Variable Annuity* (www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/p006045).

Federal Estate Tax. The value of an annuity is included in a decedent's gross estate for federal estate tax purposes, unless it is the type of annuity that stops payment upon the death of the annuitant. The amount that can be included is based on the proportion of the purchase price contributed by the decedent and the determination of the present value of the future payments to the beneficiary using appropriate IRS annuity tables and regulations.

However, if the value of the deceased's total estate including lifetime taxable gifts and the annuity is less than $5,250,000 (in 2013, adjusted annually for inflation), no federal estate tax return is required to be filed (unless the decedent is survived by a spouse and the deceased spouse's unused exemption is to be allocated to the surviving spouse) and no tax is due.

The underlying mutual funds of variable annuities do not receive a "step-up" in cost basis when the owner dies like they would if the mutual funds were purchased outside the annuity. Any deferred income in the policy will be taxable to the beneficiaries as ordinary income at their tax rates. For more information see the MSU Extension MontGuide, *Federal Estate Tax* (MT199104HR).

State Inheritance Tax. Because Montana no longer has a state inheritance tax, proceeds of an annuity pass to his/her beneficiaries inheritance tax-free.

Probate. If an annuitant has selected a survivor benefit with a named beneficiary, the proceeds are not subject to the probate process in Montana. The annuity contract with a named beneficiary has priority, so a provision in a will naming a different beneficiary would be invalid.

Who's selling that annuity?

Commercial annuities are only as good as the company selling them. Investigate the rating of the company before making a purchase. There are five major rating businesses that grade insurance companies on their financial health and ability to pay claims:

- A.M. Best Company, www.ambest.com
- Duff & Phelps, www.duffandphelps.com
- Moody's, www.moodys.com
- Standard & Poor's (S&P), www.standardandpoors.com
- Weiss, www.weissratings.com

The challenge for consumers is that each rating service has a different definition for financial stability and also different rating codes. As an example, A++ is the top grade from A.M. Best, but second on S&P's. While a high rating does not guarantee the company will remain in business, it is one of the best indicators available for consumers to gauge an insurance company's balance sheet strength and operating performance.

Montana Protections

Montana law provides protections for consumers considering the purchase of an annuity. These legal protections are enforced by the Montana Commissioner of Securities and Insurance, available online at www.csi.mt.gov or by calling 800-332-6148.

Licensing. The person who sells an annuity to a Montanan is required to be a licensed life insurance agent and, in the case of a variable annuity, also a licensed securities broker. The company selling the annuity must also be licensed in Montana. To determine if your agent/dealer and company are licensed in Montana see the FINRA BrokerCheck online at www.finra.org/brokercheck or call 800-289-9999. You can also contact the Montana Commissioner of Securities and Insurance at producerlicensing@mt.gov or call toll-free 800-332-6148.

Montana Life & Health Insurance Guaranty Association. If a life insurance company becomes insolvent and is ordered by a court to liquidate, the Montana Life & Health Insurance Guaranty Association provides protection for Montana residents who hold covered policies and contracts with the insolvent insurer. The limit is $250,000 per person. However, the coverage does not extend to any portion of a policy or contract that the insurer does not guarantee, such as investments in a variable annuity contract. All insurers licensed to sell annuities in the state are members of the Montana Life & Health Insurance Guaranty Association.

Montana Annuity Disclosure Act. The Montana legislature passed this Act to provide standards for the disclosure of minimum information about annuity contracts. When the application for an annuity contract is made in a face-to-face meeting, the applicant must be given a disclosure document and a buyer's guide.

When the application is taken by means other than in a face-to-face meeting such as mail, email, or by the internet, the applicant must be sent both the disclosure document and buyer's guide not later than five business days after the completed application is received by the insurer.

When a disclosure document and buyer's guide are not provided at or before the time of application, a free-look period of 15 days must be provided for the applicant to return the annuity contract without penalty. Many companies have a free-look period starting after the policy is physically delivered.

Items required in a disclosure document are the following:

1. Name of the contract, the company product name (if different), the form number and the fact that it is an annuity.
2. Insurer's name and address.
3. Specific dollar amount of percentage charges and fees with an explanation of how they apply.
4. Information about the surrender guaranteed rate for new contracts that contains a clear notice that the rate is subject to change.
5. Description of the contract and its benefits, emphasizing its long-term nature, including:
   a. Guaranteed elements, nonguaranteed elements and determinable elements of the contract and their limitations, if any; and, an explanation of how the elements operate;
   b. Explanation of the initial crediting rate, specifying any bonus or introductory portion, the duration of the rate and the fact that rates may change from time to time and are not guaranteed;
   c. Periodic income options both on a guaranteed and nonguaranteed basis;
   d. Any value reductions caused by withdrawals from or surrender of the contract;
   e. How values in the contract can be accessed;
   f. Death benefit, if one is available, and how it will be calculated;
   g. Summary of the federal tax status of the contract and any penalties applicable on withdrawal of values from the contract, and
   h. Impact of any rider (special features), such as long-term care.

Cautions for Annuity Investors

To help you determine whether an annuity is appropriate for your situation, the National Association of Insurance Commissioners suggests you ask the following questions:

- What is my life expectancy? Are there any factors to indicate that I will live longer or shorter than the life expectancy tables indicate? Life expectancy is particularly important when considering a private annuity. If your life expectancy is not long and you have enough assets, an annuity may not be necessary.
- How much retirement income will I need in addition to what I will receive from Social Security, my pension plan, and potential income from assets including investments?
- Do I need to provide supplementary income for other family members?
- How long do I plan to leave money in the annuity?
- When do I plan to need income payments?
- Will the annuity allow me to gain access to the money when I need it?
- What is my level of risk tolerance?
  1. Do I want a fixed annuity with a guaranteed interest rate and little or no risk of losing the principal?
  2. Do I want a variable annuity with the potential for higher earnings that are not guaranteed and the possibility that I may lose principal?
  3. Or, am I somewhere in between a fixed or variable annuity and willing to take some risks with an equity-indexed annuity?
- Did the insurance agent provide a history of the company's guaranteed renewal rates?
- Have I considered all the tax consequences of purchasing an annuity, including the effect of annuity payments on my tax status during retirement?

Summary

Annuities can be an effective retirement and estate planning tool for some people. Compare information for similar contracts from several companies. Comparing products and their costs may help you make a better decision. Consult a financial advisor for further information about commercial and private annuities for your specific situation. Discuss legal implications of private and charitable annuities with an attorney. Contact a certified public accountant about the tax implications of a commercial, private, or charitable annuity.

To assure that your annuity is accomplishing your financial goals, the contract should be reviewed periodically, as part of your estate and retirement planning process. When there is a dramatic change in your financial situation (divorce, death of spouse or other beneficiary, or birth of a child), your plans should be reviewed.

Additional resources

FINRA (Financial Industry Regulatory Authority, Inc.)
www.finra.org/AboutFINRA

Montana Commissioner of Securities and Insurance.
www.csi.mt.gov

Securities and Exchange Commission.
www.sec.gov/investory/seniors.shtml

National Association of Insurance Commissioners.
www.naic.org

California Department of Insurance video:
Annuities-It's Your Choice www.insurance.ca.gov/video/0010VideoPSA/Annuities.cfm

Internal Revenue Service: *Pension and Annuity Income*
www.irs.gov/publications/p575/index.html

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This publication has been approved by representatives of the following organizations and agencies who recommend its reading by those who are considering using an annuity as estate planning and/or retirement tool: Business, Estates, Trusts, Tax and Real Property Law Section, State Bar of Montana; Montana Commissioner of Securities and Insurance; MSU College of Business; National Association of Insurance and Financial Advisors (Montana Section); Extension Colleagues with Montana State University and University of Florida; and Montana citizens.

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