Lesson 1: Read More

TYPES OF ANNUITIES AND THEIR USES

A single premium annuity is basically just what the name implies; an annuity that is purchased with only one premium. Usually, this lone premium is fairly large. Many insurance companies have annuities designed to accept only the single premium payment and then begin paying benefits when the annuity holder elects to do so. Either deferred or immediate annuities may be purchased on a single premium basis.

However, there is another way that an annuity contract can be purchased. An individual might purchase an annuity contract that is designed by the insurance company to accept multiple premiums over a period of years. This is called a *flexible premium* contract. Since most flexible premium contracts do not require the payment of any set number of premium payments or dollar amount other than the initial premium, the purchaser could elect to pay only the initial premium . Of course, if the individual's plan is to pay only the single premium from the start, the best type of annuity to purchase will be the one which offers the best combination of rate of return, desired investment options, financial stability of the issuing company, and so forth.

Many assume that annuities, and especially single premium annuities, are financial options designed only for the wealthy. This is not true. Many individuals who purchase a single premium annuity are not wealthy, but rather have received a large sum of money at one time. Since it is likely that these funds will be needed in the future, the purchase of a single premium deferred annuity contract often makes good financial sense. If that large sum will be needed to pay current expenses, a single premium immediate annuity would be appropriate.

Take the example of Mr. Green, age 62, who recently lost his wife. He has elected to receive the death proceeds of Mrs. Green's group life insurance in a lump sum of $75,000. Mr. Green, who is self-employed and does not have any retirement plan for himself, plans to work for several more years. He does not need these funds for current expenses, but he does want to use them to supplement his income after he retires. If Mr. Green purchases a single premium deferred annuity with the $75,000 he can elect to begin receiving benefits at his retirement age and, by electing a life income settlement option, he will have an income to supplement his Social Security benefits and Mrs. Green's pension plan benefits that will continue throughout his lifetime.

Another type of individual who may benefit from the purchase of a single premium annuity is someone who works in a field where his or her income is sporadically received. Artists, actors, authors and others in the field of performing arts can fall into this category. For a successful actor, the purchase of a single premium annuity with the income from a project that was financially successful can offer freedom from future financial concerns, allowing the actor to pursue his craft without the need to consider whether a particular project will generate a certain level of income. Bob Hope made the observation, later in his career, that his purchase of an annuity when he had "extra" money made it possible for him to survive in those years when his income was substantially less.

Another person who can benefit from the purchase of a single premium annuity is a professional sports figure whose playing career will last for only a few years of his working life but will generate large amounts of income in this short time span. The single premium annuity that begins paying benefits when the sports career ends can provide financial security for the person's activities after his competitive years are finished. Yet another individual who might benefit from the purchase of a single premium annuity is a business owner who has just sold all or perhaps only a portion of his company.

Often, such sales are made due to the owner's desire to retire and an annuity can provide a retirement income. This can be especially important to a business owner or self-employed person who has not been able to set up a qualified retirement plan during the years spent building his business. Once a single premium deferred annuity has been purchased, the annuity holder can choose when to begin receiving the benefit payouts from the annuity.

If the annuity is an immediate annuity, benefit payments must begin within one year of purchase. However, if the annuity is a deferred annuity, the annuity holder may delay the receipt of benefits for years or even decades. The length of time for which the receipt of benefits can be delayed may be influenced by the maximum age for benefits to begin contained in the annuity contract itself.

FLEXIBLE PREMIUM ANNUITIES

In contrast to the single premium annuity, the flexible premium annuity allows premium payments to be made at varying intervals and in varying amounts. This type of annuity is very useful as a tool for accumulating a sum of money that will provide benefits at some point in the future.

For example: A flexible premium annuity contract might be purchased by Mrs. White to plan for her grandson's college education. Since Mrs. White wishes to keep control over the funds she will be placing in the annuity, she names herself as the owner and the annuitant of the contract. Over the next fifteen years, she will make a monthly deposit of a set amount into the annuity. Should she choose to do so, the annuity contract offers her the flexibility to make a larger monthly payment every so often. At the end of fifteen years when her grandson is ready to begin college, Mrs. White can draw the funds out of the annuity in one of several ways. She could simply surrender the annuity contract completely and pay the college expenses out of the proceeds. (The amount received from the surrender would be partially taxable to Mrs. White but would not be subject to the 10% penalty tax on premature distributions since Mrs. White would be older than 59 1/2. Alternatively, she could annuitize the contract over a five year period and use the income received each year to meet the college expenses. Should Mrs. White's grandson decide not to attend college or be awarded a scholarship, Mrs. White can elect to annuitize the contract over her lifetime and use the funds to supplement her retirement income.

As with a single premium annuity, a flexible premium annuity can be fixed or variable.

FIXED DEFERRED ANNUITIES

there are two types of fixed deferred annuities: “declared rate” and “index”. Both guarantee a minimum interest crediting rate. The declared rate type offers non—guaranteed (“current”) interest as well. Typically, current interest is declared annually although some contracts guarantee the current rate for more than one year.

An “index” annuity is a fixed annuity, not a third type in addition to fixed and variable. It has the defining characteristics of all fixed annuities – a guarantee of principal (except to the extent that surrender charges may erode principal if amounts are withdrawn early) and a guarantee of minimum interest. Current interest is linked to the positive movement of an external equity index such as the S&P 500®. An index annuity is not an investment in that equity index or in the stock market. Until recently, Index annuities were often referred to as ”equity index” annuities but this practice has declined because that term implied too many that the contract was a direct investment in equities. The term “fixed index annuity” is less misleading and has acquired widespread acceptance. All Index annuities, as of April 2014, are deferred annuities, either Single Premium or Flexible Premium; there are (at this time) no Index immediate annuities.

A “Declared rate” fixed deferred annuity example:

If Ms. Brown purchases a flexible premium “declared rate” fixed deferred annuity that is paying a current interest rate of 7%, Ms. Brown knows, without assuming any of the investment risk herself, that the insurance company will credit interest at a rate of 7% on the funds in her annuity until the date at which the current rate is altered. This will be true whether or not the insurance company earns a sufficient rate of return on its own investments to support the current rate of 7%.

Fixed declared rate deferred annuities offer security in that the current rate of return is certain, as is the long-term minimum rate of return. They also offer security in that the annuity holder does not take on responsibility for making any decisions about where or in what amount the funds in his annuity should be invested. This is in contrast to the variable type of annuity, discussed below, in which the annuity holder does take on this type of responsibility.

All deferred annuities, both fixed and variable, contain guaranteed annuity payout options. These offer the purchaser the assurance that for each thousand dollars of annuity value placed under one of these options, the insurer must pay at least the amounts calculated under these guaranteed minimums. Typically, the guarantees are stated as “annuity payout factors, per thousand”. In addition to these guaranteed minimum payouts, all deferred annuities offer *current* annuity payout rates, usually higher than the guaranteed rates, which, once payout begins, are guaranteed for the term of the payout.

Fixed deferred annuities present the possibility that interest earnings may fall behind the cumulative effect of inflation. The variable annuity, discussed below, offers one possible alternative to this outcome. Another way to guard against the possibility of falling behind inflation is offered by Index annuities.

INDEX ANNUITIES

Index annuities offer the *potential* for higher interest than that available from declared rate fixed deferred annuities, at the cost of lower guaranteed interest rates and, in many cases, longer and steeper surrender charge schedules.

In other words, an allows the holder to participate in market index increases without completely giving up the guarantee of principal and a minimum interest rate offered by the more traditional fixed annuity. In very general terms, the index annuity allows the holder to participate in *a portion of* stock market gains without assuming the risk of losing money when the market declines. In a financial environment where interest rates on fixed annuities and other financial products such as certificates of deposit are relatively low this ability to share in stock market gains with some limits on potential loss is understandably appealing to prospective annuity buyers.

One of the disadvantages of an index annuity is that because of its link to the equity index and the “moving parts” it contains that are used to calculate and credit interest, it is considerably more complex than a declared rate fixed annuity. Life insurance companies do not all calculate the rate payable on their index annuities in the same manner. In fact, there are dozens of different interest calculation and crediting rate methods.

VARIABLE ANNUITIES

variable annuities exist in two types: Immediate and Deferred.

Variable immediate annuities, like all immediate annuities, provide for an income (often for life). Unlike fixed immediate annuities however, the amount of each annuity payment is not fixed, but varies with the performance of the “investment accounts” chosen by the purchaser.

Variable deferred annuities, unlike fixed deferred annuities, guarantee neither principal nor a minimum rate of return (except for funds placed within the “fixed account”).

All variable annuities, both immediate and deferred, are *securities* under federal law and are therefore subject to a greater degree of regulation. Anyone selling a variable annuity must have the required securities licenses. Any potential buyer of a variable annuity must be provided with a prospectus, a detailed document which provides information on the variable annuity and the investment options available. Recently, a shorter summary-style document called a profile prospectus has been approved for use with variable annuities. This document, which does not replace the more detailed prospectus, provides summary descriptions of the key features of the variable annuity. Further, with any sale of a variable annuity, the person making the sale must ascertain that the variable annuity is a suitable choice for the individual purchaser.

The following discussion addresses those attributes unique to the variable type of annuity. However, there are many other attributes that are common to fixed, equity-indexed, and variable annuities.

Included in this list of shared characteristics are typical annuity contract charges and fees, methods of interest rate crediting, issue ages, minimum premium payments, settlement options, surrender charges, and annuity contract withdrawals.

Assumption of the Investment Risk

This assumption of risk by the holder of the annuity is a key element of the variable annuity; it is the product's most distinguishing characteristic. By way of explanation, consider the risk assumed by Mr. Black who has just purchased a declared rate fixed deferred annuity. The insurance company from which the purchase was made has promised to credit the funds in Mr. Black's annuity with a current interest rate of 6.5% for the next contract year. After that, the funds will be credited with the new current rate declared by the insurance company unless the current rate is less than the annuity's guaranteed rate of 4.5%. In any event, Mr. Black will receive at least the guaranteed rate on his funds regardless of how well or how poor the insurance company's investments perform during that time period. In other words, if the investments of the insurance company provide a return that is less than predicted, with a fixed annuity it is the insurance company who must still meet its obligations on the interest rates it has declared on its annuity contracts. It is the insurance company who has assumed the risk that investment returns will be less than expected.

In contrast, with a variable annuity, it is the annuity holder who assumes this risk. To illustrate, assume that Mr. Black, mentioned above, was concerned that the return on his annuity premium dollars not be out paced by the inflation rate over a period of time. To combat this possibility, Mr. Black decided to purchase a variable deferred annuity which offered investment choices of a guaranteed account, a stock fund emphasizing growth potential, a stock fund emphasizing income potential, a money market fund and a bond fund. With the inflation factor in mind, Mr. Black allocated 75% of his premiums to the stock fund that emphasizes growth potential and the remaining 25% to the variable annuity's guaranteed fund. On the funds in the guaranteed account, which functions similarly to a fixed annuity, Mr. Black will receive the current interest rate of 3.5%. On the funds in the stock fund, however, Mr. Black has no guarantee from the insurance company or any other party that he will receive a certain rate of return. In fact, he has no guarantee from any party that he will not lose part – or even all - of the premium dollars that he has allocated to the variable investment account.

The Investment Options — The Variable Accounts

A variable annuity typically offers an annuity holder several different investment accounts (often called "separate accounts" or "subaccounts") in which to invest all or a portion of the premiums paid into the annuity. Some contracts offer dozens of such accounts. When an annuity holder purchases a variable deferred annuity, he determines which portion of his premium payments, usually on a percentage basis, will be allocated to (or paid into) the different variable accounts. Once this percentage is determined, it remains in effect until the annuity holder notifies the insurance company that he wishes to alter his allocation arrangement. In addition to changing the amount of premium going into a certain variable investment account, most variable annuities allow an annuity holder to transfer funds between accounts, subject to certain dollar amount and timing limitations.

A typical variable annuity might offer the following investment options:

1. Money Market Account;
2. Government Securities Account;
3. Bond Account;
4. Total Return (or Balanced) Account;
5. Growth (or Common Stock) Account;
6. Growth with Income (Stock) Account; and
7. Guaranteed Account.

The Investment Options — The Guaranteed Account

As mentioned earlier, most variable annuity contracts offer a guaranteed account as an investment option. Another term often used to refer to a guaranteed account is a fixed account. The account takes its name, whichever one is used, from the fact that the interest rate paid on any funds placed in this type of account by the annuity holder receive a fixed current rate of interest. For example: If Mr. Green places $5,000 in the guaranteed account of his variable annuity when the current interest rate is 4%, Mr. Green knows that he will be paid 4% on the funds in this account for the current interest rate period.

Transfers Among Investment Accounts

A variable annuity will allow the annuity holder to transfer funds from one investment account to another. This flexibility to reposition investments under the umbrella of the variable annuity offers the annuity holder the opportunity to change his investment focus in response to changes in the market generally or to changes in a specific industry in which he may have invested heavily. It also allows an annuity holder to change the level of risk that he is willing to accept as his tolerance or desire for risk increases or decreases.

For example: An annuity holder who purchases a variable deferred annuity at a young age, say 35, and plans to use the funds for retirement will usually be willing, and financially able, to assume a fair degree of risk and volatility in his rate of return as a trade-off for the potential of significant growth in the value of his annuity. This same annuity holder at age 60 will not be as likely to assume such a high degree of risk, preferring instead a lower risk level and more income-oriented, rather than growth-oriented, investments.

The ability to transfer funds from one investment account to another allows this annuity holder to reposition his premium dollars over the years in a manner consistent with his changing investment outlook.

Most variable annuities (either immediate or deferred) place some limitations on either the number of transfers between accounts or the amount that may be transferred out of or that must remain in a particular account. Often, the limitations on transfers between investment accounts are different for transfers made during the accumulation phase of the deferred variable annuity than they are for transfers made while benefits are being paid out during the annuitization phase. After benefit payments begin, transfers may not be permitted in or out of the guaranteed account and may only be permitted between the variable investment accounts on certain dates during the year.

Benefit Payments from Variable Annuities

When the time comes to begin receiving benefit payments from a variable annuity contract, the annuity holder must decide what portion of the payments he wishes to receive as a fixed annuity and what portion as a variable annuity. There are usually no requirements, under the annuity contract, that a certain portion be under the fixed option or a certain portion be under the variable option. If he so desires, the annuity holder may receive the full amount of his annuity benefit payout on a fixed basis, on a variable basis, or under some combination of the two options.

Fixed Annuity Benefit Payout

Under the fixed annuity option, the benefits will be calculated and paid to the annuity holder in a manner similar to that used with a fixed annuity. At the time benefit payouts are to commence, all funds in the variable annuity are transferred into the general account of the insurance company and the insurance company agrees to pay an annuity which will not vary in amount from one payment to the next. In other words, if the entire benefit amount will be paid under the fixed annuity option, each check that the annuity holder receives will be for the same amount.

Variable Annuity Benefit Payout

In contrast to the fixed annuity option, an annuity holder who elects to receive all or part of his benefit payouts under the variable option will not receive a check for the same amount each month.

To understand why and how the benefit payment amount will vary under the variable payout option, it is necessary to understand the concept of "annuity units." An annuity unit is a unit of measure used to determine the value of each income payment made under the variable annuity option. How the value of one unit is calculated is a fairly complex process involving certain assumptions about investment returns. It is probably sufficient to understand that the amount of each month's variable annuity benefit payment is equal to the number of annuity units owned by the annuity holder in each investment account multiplied by the value of one annuity unit for that investment account.

Variable Annuity Death Benefit

Most nonqualified annuity contracts, including variable annuities, provide that if the annuitant dies before the contract has started paying out benefits, a death benefit will be paid to the beneficiary named in the annuity contract. Unlike the death benefit of a life insurance policy, the death benefit of any deferred annuity is not entirely tax-free; the "gain" (the difference between the contract value and the investment in the contract) is always taxable – either to the contract owner during life or to a beneficiary after death. Nonetheless, the death benefit of a deferred annuity does offer the annuity holder a guarantee that he will not lose all of the funds he has paid into the annuity if he should die before he begins to receive annuity benefit payments.

The exact manner in which the amount of the death benefit is calculated varies from one contract to the next, particularly among variable annuity contracts. One garden-variety method makes the death benefit equal to either the amount of premiums paid or the annuity's account value. (Generally, any surrenders made against the contract are subtracted from this amount when arriving at the death benefit figure.) In addition to the standard death benefit just described, variable deferred annuities often offer a Guaranteed Minimum Death Benefit, which may exceed the contract's cash value. Typically, this guaranteed death benefit uses three values, with the death benefit being equal to the largest value. The three values are the contract value, the premiums paid into the annuity credited with a certain (usually fairly modest) interest rate, and value of the annuity contract on the most recent policy anniversary plus any premiums paid since this date. The Guaranteed Death Benefit is usually an optional provision for which an additional charge is assessed.

This is in contrast to the situation with a fixed annuity where the death benefit that will be paid generally will never be less than the amount of premiums (less any surrenders) the annuity holder has paid into the fixed annuity contract. A variable annuity holder may derive some peace of mind from knowing that his beneficiary will receive a death benefit payment that is not calculated solely on the current annuity value of the contract upon the day of his death.

IMMEDIATE ANNUITIES

An immediate annuity is one which must begin paying benefits within one year of the time it is purchased. By its nature, an immediate annuity is almost always purchased with a single premium. The immediate annuity is all about income; there is no accumulation phase. An immediate annuity may be other fixed, where annuity payments are guaranteed to be either level or increasing by a specified percentage each year, or variable, where the amount of each year's annuity payment varies with the performance of the investment accounts chosen by the contract owner.

An immediate *Period Certain* annuity is often appropriate where the purchaser needs a specific amount of income for a specific period of years on a fully guaranteed basis. An immediate *Life* annuity is ideal with a consumer who wants an income for life on either a fully guaranteed basis (fixed immediate life annuity) or where the annual income payments will vary with investment performance, offering the opportunity to hedge inflation (fixed variable life annuity).

If the consumer wants both an income for life and a guarantee of a death benefit after he or she dies, no immediate life annuity can provide both, because in all life annuities, even those with refund features, a death benefit will no longer be payable if the annuitant lives long enough. Of course, an immediate annuity can be paired with a life insurance policy to meet both goals on a fully guaranteed basis.

DEFERRED ANNUITIES

A deferred annuity is one under which the annuity holder defers or delays the receipt of the benefit payouts until a later date. Most deferred annuity contracts provide a great deal of flexibility concerning the timing of premium payments and the benefit payouts.

A deferred annuity's existence can generally be divided into two parts: the accumulation phase and the annuitization phase. During the accumulation phase the annuity holder makes premium payments into the annuity upon which the issuing insurance company credits some rate of interest. This accumulation phase may last only a few years or it may continue for many years.

When the annuity holder decides to stop paying premiums into the annuity and begin drawing benefit payments out, the annuity moves into the annuitization phase. Depending upon the method of benefit payment selected, this phase could last only a few years (in the case of a short fixed period settlement option) or even beyond the annuitant's lifetime (in the case of an annuitant who dies before the end of the settlement option's guarantee period.)

For example: Mr. Brown might purchase a deferred annuity at the age of 40 with the purpose of accumulating an amount of money over the next 25 years that would be used to supplement his retirement income. This plan works well with Mr. Brown making monthly premium payments for five years. At age 45, he decides to start his own consulting service and, in view of his start-up costs and reduced income, makes no premium payments for the next five years. At age 50 Mr. Brown inherits a substantial sum of money from his favorite uncle and decides to add several large premium payments to his existing annuity. At age 55, he decides to annuitize the contract and begin receiving benefits over his lifetime. Although Mr. Brown does not consider himself to be officially retired at age 55, he wants the financial freedom to work fewer hours and have more time to fish.

The annuity that Mr. Brown purchased at age 40 with the original plan of making regular monthly payments for 25 years and then receiving benefits at age 65 was flexible enough to allow premium payments to stop altogether, to resume in a larger amount for a few months, and then to begin paying benefits ten years earlier than planned. Although, the benefit amounts would not be the same as projected under Mr. Brown's original plan, the annuity contract provided him with a great deal of flexibility as his plans and lifestyle changed.

CHARITABLE GIFT ANNUITIES

Thus far the types of annuities under discussion have been commercial annuity contracts issued by insurance companies. While these are the most common types of annuities, by far, there are several other annuity arrangements that function in a similar manner but are used for a specific purpose. One such annuity is the charitable gift annuity. Another annuity of this type is the private annuity, discussed later.

In general terms, a charitable gift annuity is an agreement entered into by a charitable institution and an individual who wishes to make a contribution of money or property to the charity. For example: If Mrs. Green wishes to donate a piece of land to the Children's Hospital under a charitable gift annuity, she will receive an annuity from the hospital for the remainder of her lifetime in return for her gift of property.

More specifically, a charitable gift annuity agreement is a contractual obligation undertaken by a charity to pay an annuity to an individual in return for an amount of cash or property transferred by the individual. It is possible that the total amount paid by the charity to the individual will exceed the value of the donated property. With this type of annuity, no annuity contract is issued. Rather, the contractual obligation is backed by the charity's assets. For tax reasons, the property that is given to the charity is often property that has appreciated in value during the time it has been owned by the individual making the gift.

The tax consequences of a charitable gift annuity are complex. They involve an immediate income tax deduction for the person making the gift. The amount of this deduction may be limited. Also, there is income tax due on a portion of the annuity payments received by the individual. In addition, part of the annuity payments is treated as a recovery of principal which may consist of part taxable gain and part excludable adjusted basis.

PRIVATE ANNUITIES

Unlike the commercial annuity contracts sold by insurance companies, a "private" annuity is an arrangement between two individuals that does not involve the purchase of an annuity from an insurance company or any other institution. Rather, one individual transfers property to another individual in return for a promise that the person receiving the property will pay an annuity for life to the person making the transfer.

Often, the private annuity is used by members of the same family to transfer a full or partial interest in a business or piece of real estate. For example: Mr. Green, a widower, owns the family farm estimated to be worth $1,000,000. He wishes for his daughter and son-in-law to own the farm since he has no other children and they are already managing the farm for him. He does not want to wait until his death to make the transfer, largely because of certain estate tax considerations.

He would be willing to sell the farm to his daughter but, since both she and her husband work on the farm and have no significant savings, they could not pay the purchase price without taking on a significant mortgage. Mr. Green could simply make a gift of the farm but this presents two problems. First, a sizable gift tax would be due and, second, since the farm is Mr. Green's only asset and he has no retirement plan income (other than Social Security), he would be left without any assets or sufficient income to support himself if he gives the farm away.

By entering into a private annuity, Mr. Green could transfer the farm prior to his death and receive an income for life in return. Ownership of the farm would be transferred to his daughter and son-in-law. In return for the transfer of the farm, Mr. Green's daughter and son-in-law would agree to pay Mr. Green an annuity of a certain amount for the remainder of his lifetime. This promise to pay is not and, indeed cannot, be secured by the farm or any other asset for tax reasons.

The basic rules for taxing the payments received by Mr. Green, the annuitant, under a private annuity state that the payments must be divided into three elements. The first is a "recovery of basis" element. The second is a "gain element" which is eligible for capital gain treatment for the annuitant's life expectancy, but taxable as ordinary income afterwards. The third is an “annuity element” that is taxable as ordinary income.

From an estate tax viewpoint, in the usual private annuity transaction the annuitant’s transfer of the property given in exchange for the annuity is complete and absolute. Since the annuity payments cease at the death of the person receiving them there is nothing to be taxed in his estate. Under such circumstances, no part of the transferred property is includable in the annuitant’s estate for estate tax purposes.

From a gift tax perspective there is no gift if the purchase of the private annuity is a bona fide ordinary business transaction. However, where closely related parties are involved, a gift may be considered to have been made in certain circumstances. But even in a transaction involving family members, if generally equal values are exchanged and there is no intent to make a gift, there will be no gift.