Lesson 2 –Parties to the Contract

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As mentioned earlier, an annuity contract is just exactly that; a contract in which certain parties make certain promises and other parties have certain rights. It is important to understand who the parties are to the contract as well as to be familiar with the rights and obligations of each party.

Generally, there are four potential parties to a nonqualified annuity contract — the owner, the annuitant, the beneficiary, and the issuing insurance company. The rights and duties of each of these entities are discussed in this course. As a general overview, think of the owner as the person who purchases the annuity and the annuitant as the individual whose life will be used in determining how payments under the contract will be made. The beneficiary is the individual or entity that will receive any death benefits that become payable under the annuity contract and the issuing insurance company is the organization that accepts the owner's premium and promises to pay the benefits spelled out in the contract.

Although there are four potential parties to each annuity contract, the most common situation involves only three parties since the owner and the annuitant are more often than not the same individual. Thus, the three parties are the owner-annuitant, a second individual or entity who is the beneficiary, and the insurance company. As an example of this commonly used arrangement, consider Mrs. Brown who has just attended the college graduation ceremony of her youngest child and now is turning her attention to seriously planning for her retirement years. One of the recommendations she receives is to purchase a nonqualified deferred annuity now and place $200 each month into the annuity.

When she retires the contract will move from the accumulation phase to the pay-out phase and begin providing Mrs. Brown with a monthly benefit. In setting up the annuity, Mrs. Brown will be named as both the contract owner and the annuitant. She will name a beneficiary for any death benefits that are paid from the contract in the event she dies before she reaches retirement age. Most likely, Mrs. Brown will name one of her children as the beneficiary. The third party, the insurance company, will be the organization from which Mrs. Brown purchases the annuity.

THE OWNER

Every annuity contract must have an owner. Usually the owner is referred to as either the owner, the contract owner, or the annuity owner. Another name that is sometimes used is the annuity holder. With a nonqualified annuity contract the owner is usually a real person, someone who has decided to purchase the annuity as part of a financial plan for retirement or some other purpose. However, there is no requirement that the owner be a real person, as there is with the annuitant. Any entity can own an annuity contract, including various types of trusts and a business that is organized as a corporation or a partnership.

In the most common instance where the owner and the annuitant are the same person, the owner pays money in the form of premiums into the annuity during the accumulation phase. At the end of this phase, the owner-annuitant begins to receive the annuity benefit payments from the insurance company.

As the term “owner” implies, the owner of the annuity contract holds a number of rights under the contract. It is the owner of the annuity who names the individual who will serve as the annuitant as well as the individual or entity who will be the beneficiary under the contract. Also, it is the owner who has the right to determine when the annuity contract will move from the accumulation phase into the payout (or annuitization) phase and begin paying benefits. For example: If Mr. Green purchased a single premium annuity twenty years ago, as owner of the annuity contract, he can choose to begin receiving annuity payments today or to wait until some point in the future. (Most annuity contracts do specify a maximum age past which annuity payouts cannot be deferred, but in most contracts this age is well past the usual retirement age.)

Under a typical annuity contract, Mr. Green also has the right to make a partial surrender and receive a portion of the funds accumulated inside the contract. Additionally, he can choose to end the contract completely by fully surrendering the contract. To illustrate Mr. Green’s options in this respect, assume that the contract value today is $50,000. As owner of the contract, Mr. Green may make a partial surrender of an amount less than the full $50,000 value. If he chooses to receive $20,000 from the contract, the annuity contract will continue in force but with a reduced value of only $30,000.

When Mr. Green chooses to begin receiving the annuity benefit payments, he will be entitled to benefits calculated on the remaining $30,000 value in the contract. Mr. Green, as owner of the contract, can also choose to fully surrender the contract, receiving the entire $50,000 value today. Should he decide to do this, the annuity contract will be at an end and neither Mr. Green nor the insurance company will have any further rights or obligations relating to the annuity.

THE ANNUITANT

The annuitant is the individual named under the annuity contract whose life will serve as the measuring life for purposes of determining benefits to be paid out under the contract. According to the Internal Revenue Code, the annuitant is the individual whose life is of primary importance in affecting the timing or amount of the payout under the contract. In other words the annuitant’s life is the measuring life. Thus, it seems obvious that the annuitant, unlike the owner and the beneficiary of the annuity contract, must be a real flesh-and-blood person.

Although it is the most common arrangement, there is no requirement that the owner of the annuity contract and the annuitant be the same individual. An example taken from the Deficit Reduction Act of 1984 illustrates this. In discussing the distributions that are required to come from an annuity contract at the death of the owner, the General Explanation of this piece of legislation gives an example in which a father, age 50, buys an annuity contract and is the owner. He names his son, age 25, as the annuitant, with annuity payments to begin when his son reaches age 45.

When the accumulation phase of the annuity draws to a close and the owner wishes to annuitize the contract and begin receiving annuity benefit payments, the life expectancy of the annuitant can come into play, depending upon which annuity payout or settlement option is elected. For example: If Mr. Jones is both the owner and annuitant of an annuity that will begin paying benefits when he is age 65 and the payout option he elects is a life only option, the fact that Mr. Jones has a life expectancy of 20 years will be used in calculating the portion of the benefit payout that will be taxed to him. The 20 year life expectancy figure is taken, for income tax purposes, from the applicable annuity table issued by the Internal Revenue Service.

In addition, a similar life expectancy figure will be used by the insurance company that sold the annuity to Mr. Jones in calculating the amount of his monthly annuity benefit. Thus, the annuitant's age (and therefore his or her life expectancy) at the time the benefit payout begins will affect this monthly benefit amount. For example: Assume that Mr. Brown is the owner-annuitant of a nonqualified annuity contract which currently has an accumulation value of $50,000. If Mr. Brown decides to begin receiving annuity benefits now at age 65, his benefit will be about $334 per month under a life only settlement option. However, if Mr. White, who is currently 75 years old, begins to receive benefits from his annuity which has an accumulation value of $50,000, his monthly payout amount under a life only settlement option will be about $471 per month. If Mr. Green decides to take advantage of his employer's offer of early retirement and, therefore, is only 55 years old when he annuitizes his $50,000 annuity contract under a life only settlement option, his monthly benefit amount will be only $265.

THE BENEFICIARY

Similar to the beneficiary of a life insurance policy, the annuity contract beneficiary receives a death benefit when another party to the annuity contract dies prior to the date upon which the annuity begins paying out benefits. Payment of such a death benefit arises under a provision of the individual annuity contract and is not mandated by the laws of federal taxation. Rather, most insurance companies offer the payment of a death benefit if the owner of the annuity contract (or in some situations, the annuitant) dies before the contract begins paying benefits as a method by which the owner may recover his annuity premiums when death occurs earlier than anticipated. In effect, the payment of the death benefit allows an owner to recover his investment and pass it along to his beneficiary if he does not live long enough to begin receiving annuity contract benefits. The death benefit amount is equal generally to the value of the annuity contract at the time of death, but may be greater if the contract includes a "guaranteed minimum death benefit".

As an example: Assume that Mrs. Smith purchased an annuity naming herself as both the owner and the annuitant. Mrs. Smith names her nephew, her only living relative, as the beneficiary of the annuity contract. Mrs. Smith purchased the deferred annuity contract when she was 50 years old and does not plan to begin receiving benefits (i.e., annuitize the contract) until she retires at age 65.

If Mrs. Smith dies prior to retirement, the typical annuity contract will pay a death benefit to her nephew approximately equal to the premiums that Mrs. Smith paid into the annuity plus the interest

earned on those premiums. The payment will be made to the nephew, as the annuity contract beneficiary, directly.

If, however, Mrs. Smith survives until she retires at age 65, begins receiving benefits from the annuity under a “life only” income option, and then dies at age 67, there will be no death benefit payable to the beneficiary or any other party. This will be true even though Mrs. Smith had not received in two years time benefit payments anywhere close to the amount of premiums she paid into the annuity. Iff Mrs. Smith had elected a method of benefit payout that offered a refund or a guarantee instead of the life only income option and died before the expiry of that guarantee, some further benefit payments would be made to her nephew. Most annuity contracts offer a variety of benefit payout or settlement options.

Payment of the death benefit at the death of an owner or annuitant is altered somewhat when there is a surviving spouse that has been named as the beneficiary under the contract. The Internal Revenue Code allows a surviving spouse to “step into the shoes” of the deceased spouse. In effect, the surviving spouse becomes the new owner of the annuity and is permitted to continue the annuity contract without change. For example: Assume that Mr. Green purchased a single premium deferred annuity five years prior to his death, naming himself as owner and annuitant and his wife, Mrs. Green, as the designated beneficiary. He had not yet started to receive payments from the annuity contract at his death. Mrs. Green, as the designated beneficiary, would be treated as the annuity contact owner, and would be allowed to continue the annuity in its accumulation phase for the time being.

The beneficiary has no rights under the annuity contract, other than the right to receive payment of the death benefit. He cannot change the payout settlement option,alter the starting date for benefit payments, ormake any withdrawals or partial surrenders against the contract. Further, the owner has the right, under most nonqualified annuity contracts, to change the beneficiary designation at any time. However, some annuity contracts do permit a beneficiary designation to be made irrevocably. If this is the case, the irrevocable beneficiary does have certain rights under the contract.

Unlike the party named as the annuitant under an annuity contract, there is no requirement that the beneficiary be a flesh-and-blood individual. Often, a trust or other entity such as a charitable organization is named as the annuity contract beneficiary.

One situation that should be avoided at all costs is the so-called “triangle trap”, which exists with both life insurance policies and annuity contracts. Where the owner, beneficiary, and annuitant (or, in the case of a life insurance policy, the insured) are three different parties, and where the death benefit will be payable upon the death of the annuitant (or insured), that death will trigger unfortunate and probably unexpected tax results. The owner will be deemed to have made a taxable gift of the policy proceeds to the beneficiary. Moreover, in the case of an annuity, the beneficiary will be required to pay not only income tax on the contract “gain” (the amount of tax-deferred interest remaining in the contract), but also a 10% penalty tax on that “gain” unless he or she is over the age of 59 ½ or elects to take the death benefit in the form of a life annuity.

THE INSURANCE COMPANY

It is the insurance company who issues the annuity contract and, in doing so, assumes a number of financial obligations to the owner, the annuitant, and the beneficiary. It should be remembered, also, that the contract obligations undertaken by the issuing insurance company are different for other types of annuities such as Individual Retirement Annuities (IRAs), Tax Sheltered Annuities (TSAs) and annuities issued in connection with qualified retirement plans. It is important to remember these differences.

In a very general sense, the insurance company that issues a *fixed* annuity contract promises to invest the owner's premium payments responsibly and credit interest to the funds placed in the annuity. By contrast, the issuer of a *variable* annuity assumes no investment risk. The purchaser assumes that risk.

In addition to investing the owner's premium payments and crediting the funds with interest, the insurance company also promises to pay the contract death benefit in the event of the death of the owner – or, in the case of "annuitant-driven" deferred annuities, *either* the owner's or annuitant's death - prior to annuitization of the contract and to make benefit payouts according to the contract settlement option selected by the contract owner. By fulfilling these contractual obligations, the insurance company, through the annuity contract, helps the owner to avoid outliving his or her financial means.

While it may seem at first glance that an annuity contract issued by one company is just the same as a contract issued by any other company, the truth is that annuity contracts do differ from one company to the next. The Internal Revenue Code does require that all annuities contain certain provisions in order to be eligible for the tax benefits associated with the annuity contract, but there remains considerable room for variation between companies.

Which annuity contract is right for a certain individual depends upon the facts of the individual's situation. For example: All companies have a maximum age past which they will not issue an annuity contract. If an individual is 80 years old, he or she will not be able to purchase an annuity contract from a company whose maximum issue age is 75, even if all the other components of that particular annuity are attractive. Annuity contract provisions vary in many regards among issuing companies including surrender charges, interest rates credited, and settlement or payout options available to name only a few. The best source of information on the specific provisions of an annuity contract is, of course, the issuing insurance company itself. Many agents and financial planners request a sample contract for each of the annuity products they work with to maximize their understanding of each annuity contract.

As mentioned above, one item that must be considered in relationship to the insurance company is the various provisions and strengths of the annuity contract itself. Of similar importance, is the financial strength and investment philosophy of the company that is issuing the contract. The purchaser of an annuity contract should be knowledgeable about and comfortable with this information.

To evaluate the company's financial strength, several "rating" services are available and, indeed, are used extensively by agents, financial planners, and consumers, alike. These services include those from the A.M. Best Company, Moody's, Standard & Poor's, and Duff & Phelps.

The ratings services examine the items connected with the insurance company that are of importance in gauging how effectively, efficiently, and profitably the company is likely to perform in the future.

Included in the list of information evaluated is the company's profitability, its capitalization, and its liquidity. In addition, ratings services generally examine the company's investment strategy and marketing philosophy, as well as the general stability of its business practices and history. The capability and competence of the company's management also comes under scrutiny during the rating process.