Lesson 3 – Standard Contract Provisions

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While all annuity contracts are not the same, there are certain standard provisions common to many. Some provisions, such as those that require distributions after the death of the owner to be made in a particular manner, are required by the Internal Revenue Code to be contained in the annuity contract. At least, these provisions must be a part of the annuity contract if the insurance company wishes the contract to retain the income tax advantages associated with an annuity.

Other provisions may be unique to the annuities of one or a small number of companies, although once a company introduces a successful innovation it is often adopted by other insurance companies. In the past few years, this tendency has been illustrated by the rapid development of the indexe annuity. Early in a product's development there tends to be greater variety among the products developed and issued by the various companies. Currently, this is true among the available index annuities. As time passes, the index annuities issued by different insurance companies may come to resemble each other more and more closely.

This course contains a discussion of the typical provisions found in a non-qualified annuity contract. Not all annuities will contain these provisions, but many do. Some contracts may contain generally the same provisions but differ as to the specific details. For example: Annuity A and Annuity B both may specify a maximum issue age for the annuity owner. However, the maximum age under Annuity A may be 75 while the maximum age under Annuity B is 80. Many agents and financial planners have found that the best way to know precisely what a particular annuity contract provides is to request a sample copy of the annuity contract from the issuing company and study it carefully. The following typical annuity contract provisions are addressed in this course:

1. bailout provisions and rates;
2. charges and fees;
3. dollar cost averaging;
4. interest rates;
5. issue ages;
6. maximum ages for benefits to begin;
7. nursing home waiver;
8. premium payments;
9. settlement options;
10. surrender charges; and
11. withdrawals.

BAILOUT PROVISIONS AND RATES

Generally, a bailout provision allows the contract holder to fully surrender the annuity contract if the current interest rate drops below a certain level without incurring any of the applicable surrender charges imposed under the annuity contract. Another name for a bailout provision is an escape clause.

For example: An annuity might offer a bailout clause that allows the contract to be surrendered if the current interest rate drops to 1% below the interest rate of a previous period. Assume that the prior interest rate was 5.5%. If the current rate for the next period will fall below 4.5% the annuity holder could surrender the annuity contract completely and not be subject to any contract surrender charges. (The 10% penalty tax on premature withdrawals may still apply to a surrender under the bailout provision.)

While the existence of this “out” from low interest rates may ease the annuity holder’s mind, as a practical matter it may not be of much value. If the issuing insurance company does not have sufficient investment returns to allow it to credit interest of more than 4.5%, other insurance companies and financial institutions are not likely to be able to do so either. Thus, even if the annuity holder retrieves his funds from the annuity, he may not have many investment alternatives that will pay a higher rate of return. Moreover, the bailout provision usually includes a “window of opportunity” (e.g.: 30 days from the announcement of the new interest rate), during which the owner must take advantage of this provision or lose its benefit.

CHARGES AND FEES

Many, if not most, annuities assess charges of an administrative nature against the funds placed in the annuity contract. Often, an annuity will apply several different charges. Although the dollar amount of each charge may seem small, the cumulative effect can take its toll.

Fixed Annuities

Many annuities assess administration fees. For example: An annuity may charge a fee of $30 or $35 annually to cover the company’s cost of preparing the annuity holder’s statement, making ownership or beneficiary changes, etc. this charge is typically waived when the contract value exceeds a specified amount. Typically, the fees associated with a fixed annuity are lower in amount and fewer in number than those applicable to a variable annuity. At first glance, it may seem that the variable annuity is more “expensive” than the fixed annuity.

However, this is not necessarily true. With a fixed “declared rate” annuity, the insurance company declares the current interest rate and thus can set the interest rate it promises to pay at a lower rate than the rate it expects to earn on its investments. This difference in rates, sometimes referred to as the “spread” or “haircut,” allows the insurance company more leeway to recover its administrative costs than the insurance company has with a variable annuity where it does not set the interest rate itself but credits the rate earned on the funds in the underlying separate investment account. In a fixed *index* annuity, the interest rate that the insurer will credit to the contract is determined by the “moving parts” in the contract (i.e.: the “participation rate”, “interest rate spread”, “cap rate”, and “averaging” provisions).

Variable Annuities

Fees and charges levied under variable annuity contracts, while somewhat similar to those charged by fixed annuity contracts, are subject to a greater degree of regulation due to the fact that variable annuities are considered to be securities. In very general terms, this means that a variable annuity purchaser must always be given a prospectus and that an agent or planner must have a securities license in addition to the one required to sell fixed annuities.

The annual fee mentioned above in relation to the fixed annuity often is applied to a variable annuity contract, also. With a variable annuity, charges of this nature are usually deducted proportionately from the various separate investment accounts in which the annuity holder has placed his funds. For example: If Mr. Black has placed 50% of his funds in the bond account and 50% in an equity account, each account would be charged with 50% (or $15) of the $30 annual administration fee. Some variable annuity contracts waive the contract fee when the annuity’s accumulation value exceeds a certain threshold such as $50,000.

Also with a variable annuity, the various "investment accounts" each impose an investment management charge. The amount of these charges vary; typically, this charge in actively managed accounts is greater than in passively managed accounts (such as "index accounts" which seek to mimic the performance of an equity index such as the S&P 500®).

Another type of expense imposed in variable deferred annuities is the "M&E" or "Moratality and Expense" charge, which may include, or be separate from, and administrative charge. I the These charges together usually amount to 1-1.4% of the total value of the investment accounts, although in some "low cost" contracts, may be much lower. Typically, variable deferred annuity contracts with extremely low annual expenses offer less generous death benefits and may not offer optional riders such as the "Guaranteed Lifetime Withdrawal Benefit".

The following illustration brings these typical fees and charges together. A typical variable annuity contract might provide for the following fees:

- an annual administration fee of $35;
- an investment advisory fee equal to .15% of the average account value; and
- an M&E charge equal to 1.25% of the average account value.

Of course, with a variable annuity, the costs and fees are disclosed in the annuity's prospectus.

Another fee that is charged under a few variable annuities is a fee for the transfer of funds between investment accounts. Typically, a variable annuity will allow the annuity holder to transfer funds from the guaranteed account to one or more of the variable accounts or from the variable accounts to the guaranteed account. Transfers between variable accounts are usually also permitted, although any transfer may be subject to restrictions concerning its timing or amount. Today, most contracts permit these transfers without charge, although many reserve the right to levy such charges in the future. Some variable annuity contracts allow a certain number of transfers per year without charge and then assess a charge for transfers in excess of the permitted number. Typically, when a charge is assessed it amounts to $10 to $15 per transfer and is usually deducted from the account from which the transfer is made.

DOLLAR COST AVERAGING

Dollar cost averaging is, in very general terms, a system of buying securities such as mutual funds or stocks at regular intervals with a fixed dollar amount of capital. In this long-term approach to investing, an individual purchases the same dollar amount of a fund or other type of investment each month, regardless of the current share price of the fund.

By doing so, the individual buys more shares when the market price is low and fewer shares when the market price is high. The dollar cost averaging approach results in an average cost lower than the average price over a period of time.

Many variable annuity contracts facilitate dollar cost averaging by offering a type of transfer feature that allows the annuity holder to make transfers from one variable account to another on a systematic basis. A transfer is made each month or year from one account to another within the variable annuity for the purpose of purchasing whatever amount of the new fund can be purchased with the same amount of dollars each month. Many annuity contracts place limits on the amount that can be transferred, the amount that must remain in an account, and which accounts the transfers can go into or come out of.

For example: An annuity might allow dollar cost averaging and restrict transfers to a fixed dollar amount of at least $100 coming out of the general or guaranteed account and going to certain variable accounts. Some annuities also allow an annuity holder to transfer the interest earned in the guaranteed or general account into another variable account for use in dollar cost averaging.

INTEREST RATES

Fixed Annuities

Typically, a "declared rate" fixed deferred annuity contract will offer two interest rates: a guaranteed rate and a current rate. The guaranteed rate is the minimum rate that will be credited to funds in the annuity contract regardless of how low the current rate sinks or how poorly the issuing insurance company fares with its investment returns. Typically, the guaranteed rate is 2-3%

The current interest rate varies with the insurance company's success or lack of success with its investment program. Some annuity contracts revise the current rate on a monthly basis, others change the current interest rate only one time each year.

"Declared rate" fixed deferred annuities may credit interest on either a "portfolio rate" or "new money" ("pocket of money") approach. A variation of this approach is the "tiered" interest method, where the first $xxxx of cash value is credited with one rate, and the excess with a different (usually higher) rate. Alternatively, all cash value might be credited with one rate if the contract is annuitized (where that rate is paid on the "annuitization value" and a lesser rate if the contract is not annuitized (where that rate is paid on the "cash value").

In the portfolio rate approach, all existing contracts are credited with a single "current" interest rate. In the "new money" approach, the interest rate paid on premiums paid to an existing contract will depend upon when those premiums were paid. Thus, a contract might be credited with 3.5% on premiums received from June 1, 20xx to August 31, 20xx and with 3.2% on premiums received from September 1, 20xx to December 31,20xx.

Some annuities offer a current rate for a one year period, a three year period and a five year period. Some contracts even offer seven and ten year periods for current interest rates. A typical provision of this type might offer a current interest rate of 5.3% for one year, 5.6% for three years, and 5.85% for a five year period. Often, these "Multi-Year Guarantee Annuities" (MYGAs) will contain surrender charges which expire at the end of the interest guarantee period. They are sometimes known as "CD annuities" because they mimic the interest crediting method used in certificates of deposit.

Variable Annuities

Understanding how returns are credited on money invested in the "investment accounts" ("variable accounts" or "subaccounts") of a variable annuity can be a bit more complicated than with a fixed annuity. With the variable annuity, the annuity holder may allocate his premium dollars among a number of investment choices including, usually, a guaranteed account, a stock fund, a bond fund, an income fund, and a growth fund. (Many variable annuities offer additional investment options.)

Funds placed in the guaranteed account of a variable annuity are credited with a fixed rate of interest in much the same manner as funds invested in a fixed annuity contract. There is a guaranteed interest rate and a current interest rate. The current rate changes periodically but will not drop below the guaranteed rate.

It is the annuity holder, not the insurance company, who assumes the investment risk for funds placed in the variable accounts of a variable annuity. Thus, the value of the contract owner's cash value that he allocated to "Stock Fund A", for example, will vary with the investment performance of that account; it may rise or fall over time. There is no guarantee, either of safety of principal or of investment return, on any money allocated to one of these investment accounts.

To illustrate further, assume that Mrs. Green, mentioned above, purchased a variable annuity with her single premium. She allocated 50% of her $100,000 premium to the guaranteed account, 30% to a stock account and the remaining 20% to a bond account. In the first contract year, $50,000 of her money would be credited with the current rate for the guaranteed fund. Her remaining money, allocated to the stock and bond accounts will rise or fall in value depending upon the performance of those accounts.

ISSUE AGES

Regarding the oldest age at which an insurance company will sell an annuity to an individual, some companies set a maximum age and some do not. Some companies set a lower maximum issue age for the annuitant than for the owner of the annuity. Some companies set a maximum issue age only for annuities that will be paid out over the annuitant's life.

A typical maximum issue age is age 90 for both the owner and the annuitant. However, some companies set the maximum for the annuitant (i.e., the measuring life) a bit lower. Thus, the maximum issue age for the annuitant might be age 80 but the maximum issue age for the owner might be age 85.

Notice that the typical maximum issue age is well beyond the age at which most individuals retire. Thus, annuities may be used for retirement planning even after retirement has commenced. Single premium annuities and immediate annuities can be particularly useful in this regard.

Joint and survivor annuities also have maximum issues ages. A typical provision states that the annuity will be issued for ages 35 to 85. The maximum issue ages typically relate to the youngest annuitant.

MAXIMUM AGES FOR BENEFITS TO BEGIN

Non-qualified Annuities

Under the Internal Revenue Code, there is no age at which distributions or benefit payments must begin for a non-qualified annuity contract. Distributions from annuities held in the IRA or qualified plan accounts must be made in accordance with the rules for those accounts. For example, Traditional IRA annuities must begin payouts no later than age 70 ½ and the amount of each year's annuity payment must meet RMD (Required Minimum Distribution) rules. Annuities held in Roth IRAs, by contrast, are not subject to Required Minimum Distributions while the account holder is living.

However, most insurance companies specify a maximum age at which the non-qualified deferred annuity holder must begin receiving benefit payouts from the contract. Like other annuity provisions, this maximum age varies, and indeed, in recent years, has generally been set at increasingly older ages. Many contracts currently require an annuity contract to begin paying benefits when the annuitant reaches age 80 or 85, although some allow the payment of benefits to be postponed to an even older age. Some annuities allow the payment of benefits to be delayed past age 100.

Other Annuities

As mentioned above, the Internal Revenue Code does set a minimum age for benefits to begin to be paid out of certain types of annuities. Generally, these are annuities into which the funds were placed either by an individual's employer, such as a qualified retirement plan, or by the individual on a tax-deductible basis, such as with some contributions to traditional IRAs. Rules for minimum distributions and the age at which they must begin are complex for these types of plans.

NURSING HOME WAIVER

Some annuity contracts offer a waiver of the annuity contract's surrender charges in the event that the annuitant is either hospitalized or confined to a nursing home for at least a minmum period, such as 30 days. This provision allows the owner of the contract to extract from the annuity contract funds needed to pay expenses for nursing home confinement or qualified home health care. Often, a deferred annuity contract will waive surrender charges if the contract owner has contracted any of certain "dread diseases" or or is certified to be terminally ill.

Although not part of the annuity contract, the 10% premature distribution penalty tax may be applicable to a withdrawal made for this reason if the taxpayer is under age 59 1/2. To avoid the imposition of this tax penalty, the taxpayer must be able to qualify as being “disabled” as that term is defined in the Internal Revenue Code. The Code’s definition may differ from the definition used in the annuity contract. In the Internal Revenue Code, for purposes of the 10% premature distribution penalty tax, “disabled” is defined as being “... unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.”

PREMIUM PAYMENTS

Most annuity contracts require each premium payment to be at least a certain minimum amount. This is primarily to make the administration of the contract easier. The required minimum amount varies widely from one annuity to another. For example: One non-qualified deferred annuity might require a minimum monthly premium of only $50, while another non-qualified annuity might require a minimum initial single premium of $25,000 with subsequent payments subject to a minimum of $50. Yet another annuity might require an initial premium of $2,000 but state that subsequent premium payments must be at least $1,000. Often, a single insurance company will offer several versions of one annuity contract with varying minimum premium requirements. Usually, the higher the required minimum premium, the more likely the annuity is to offer a greater number of investment options, free transfers among variable accounts and certain interest rate bonuses.

Since premium payments are continued at the election of the annuity contract holder, he or she may choose to skip a payment, to increase or decrease the amount of the premium, or to discontinue premium payments altogether. Of course, any decrease in or discontinuance of the planned premium will adversely affect any accumulation amounts projected for future planning purposes.

Usually, the buyer of an annuity can choose how often he or she wishes to make premium payments. Most annuity contracts will accept premiums annually, quarterly or monthly. Many insurance companies will arrange for the funds to be transferred directly out of the annuity owner’s bank account. While this direct transfer feature may be viewed as a convenience by some it does not appeal to all individuals.

SETTLEMENT OPTIONS (“ANNUITY PAYOUT OPTIONS”)

The annuity payout options in the annuity contract are the methods under which annuity payouts will be made.

It is the annuity owner who makes the settlement option selection. It can be made when the contract is purchased or delayed until the time that benefit payments are to commence. Most annuity contracts allow the chosen settlement option to be changed with proper notice to the insurance company, so long as an annuity payout option has not commenced. Although not a complete list, the following settlement options are discussed below:

- LIFE annuity options
    - life Only – No refund
    - life with period certain guarantee;
    - life and cash refund
    - life and installment refund

    - joint and survivor life annuity (with or without a "refund feature")
- Period Certain; and
- Fixed Amount annuity.

Life Only –No Refund

If the life annuity settlement option is elected the annuitant will receive payments from the annuity until his or her death. This will be true whether the annuitant dies two years after payments begin or 25 years after payments begin. This settlement option is the purest form of insuring that the annuitant does not outlive his or her financial means.

To illustrate the "Life Only – No refund" method with an example, assume that Mrs. Brown is age 50 and decides to begin receiving payments from her non-qualified annuity under the life annuity option. If her annuity has an accumulation value of about $200,000, her monthly payments will be $906. Mrs. Brown will receive the $906 each month until her death. If she lives only a few years, say to age 55, she will have received only $54,360 in annuity benefits. The difference of $145,640 ($200,000 less $54,360) will be lost to Mrs. Brown's family and heirs. On the other hand, if Mrs. Brown survives to age 90 receiving her $906 check each month, she will have collected a total of $434,880, an amount significantly in excess of the annuity's accumulation value of $200,000. It is often believed that if the purchaser of an annuity under the "Life Only – No Refund" option dies before all of the amount annuitized has been paid out, the insurance company "keeps the money". This is not true. The insurance company uses that money to pay benefits to those contract owners who do not "die early". This is *risk pooling*, the very essence of all annuities. The insurance company knows with considerable precision how many members of a given age in a large population of annuity owners will die each year and that it does not have to have enough money to pay annuity benefits until age 100 to all of those annuity owners. The *mortality credits* generated by the actuarial certainty that a certain number will die at age 66, 67, etc. allows the insurer to pay a higher annuity payout rate to all of those contract holders then if it had to pay each of them to age 100. These *mortality credits* are the "secret" to why annuities can offer a higher annual payment, per thousand dollars of money invested than would be possible, on a fully guaranteed basis, under any non-annuity alternative.

Life with Period Certain Guarantee

This settlement option is frequently selected since it provides a hedge against loss of much of the value in the annuity if the annuitant dies shortly after the contract is annuitized. Under this option, the insurance company agrees to pay the annuity benefit for the *longer of* the annuitant's lifetime or a certain period of years. Most annuity contracts offer a choice of the period certain. Often the choices include 5, 10, 15 or 20 years, although some insurance companies qualify this election by stating that the guarantee period may not exceed the annuitant's life expectancy. Thus, a 90-year-old annuitant probably would not be able to elect the life and 20 year certain settlement option.

If Mrs. Brown, age 50, decided to annuitize her non-qualified annuity contract with an accumulation value of $200,000, under a Life Only – No Refund option, her monthly benefit payments might be about $900. Under a life and 10 year certain option, her monthly benefit might be $825. Electing the life and 15 year certain option would result in a benefit of $800 per month while choosing the life and 20 year certain option would bring a benefit of $750 per month. Thus, at Mrs. Brown's age, the difference between payments for Life Only and payments for life, but at least a 20 year period, is about $150 per month. To many, this lower monthly benefit is worth the security of the 20 year guarantee.

If Mrs. Brown had selected the life and 20 year certain settlement option at age 50 but only survived until age 65, her beneficiary would receive the monthly payment of $750 each month for the next five years. On the other hand, if Mrs. Brown lived 22 years, until age 72, the annuity payments would cease at her death and the beneficiary would not receive any payment from the annuity contract.

The life and period certain guarantee settlement option can be useful in financial planning situations where there is a set number of years until a particular benefit will begin. For example: If a married couple is in their late 50's and the sole income-earner decides to retire early, using a life and 10 year certain settlement option will insure that if the income-earner dies before reaching age 65, the annuity payments will continue to the survivor until he or she is eligible for retirement benefits at age 65.

Life Only – Cash Refund

Like the life and period certain guarantee option discussed above, this settlement option offers a hedge against the possibility of an early death. Under any life annuity settlement option, the insurance company will pay the monthly benefit for the life of the annuitant. Under the Life Only – Cash Refund arrangement, the insurer guarantees both an income for the annuitant's lifetime *and* that the entire amount annuitized will be paid out. If the annuitant dies before that occurs, the difference (the amount annuitized, less the amount paid out to that annuitant) will be paid to the beneficiary.

Joint and Survivor Life Annuity

This settlement option involves two persons and their lifetimes. Under the joint and survivor life annuity the insurance company will pay benefits during the joint lifetimes of two individuals. Often the two persons are husband and wife, and some contracts require that this be the case. (Each individual must be a real flesh-and-blood person, however. Trusts or corporations cannot serve this purpose since they do not have a life expectancy.)

Under the joint and survivor life annuity option, the insurance company pays the full benefit amount until the death of one of the annuitants. If the settlement option is a full joint and survivor annuity (Joint & 100% Survivor), the payments will continue in the full amount until the death of the surviving annuitant. Under a joint and one-half survivor annuity settlement option, payments are made in full until the death of one of the annuitants but then reduced to one-half the full amount until the death of the survivor. Many companies offer a joint and two-thirds survivor annuity, under which the payments to the surviving annuitant are equal to two-thirds the original full payment amount.

Some insurance companies offer this settlement option with a different twist. Here one annuitant is named as the primary annuitant. Payments are made in the full benefit amount until the death of one of the annuitants. If the primary annuitant dies first, the survivor receives payments of either one-half or two-thirds the original benefit amount. However, if the other annuitant is the first to die, the primary annuitant continues to receive benefit payments of the full amount.

Assume that Mr. Black is age 55 and Mrs. Black, age 50, has an accumulation value of $200,000 in her non-qualified annuity. Electing the full joint and survivor annuity settlement option would result in a monthly benefit of $854 paid to both Mr. and Mrs. Black until the death of one of them. After the first death, this same amount of $854 would continue to be paid to the survivor until his or her death. If the Blacks elected a joint and one-half survivor settlement option, the amount paid to both of them would be $944 until the first death. Then, the survivor would receive one-half the benefit amount or $472 each month until his or her death. Electing the joint and two-thirds survivor settlement option would see a benefit of $912 until the first death, with the survivor receiving two-thirds or $608 of the benefit payment.

In some instances, the survivor of the two annuitants may see a reduction in living expenses and not need as much income to live as before the death of the other annuitant. However, some financial planners point out that, depending upon the remaining annuitant's other income, length of life, and the possibility of inflation, the remaining annuitant may not see a reduction in expenses over the long term.

Life annuity payout options often (but not always) offer a "cost of living" (COLA) adjustment in the annual annuity payment. Typically this adjustment states that annuity payments will increase by a specified percentage each year (usually subject to a maximum percentage rate such as 5%). A very few insurers offer a COLA provision where annuity payments will increase by the percentage of an external index such as the Consumer Price Index.

Period Certain annuity

Probably the easiest of the settlement options to explain are the Period Certain and Fixed Amount options. The Peiod Certain option allows the annuitant to receive the annuitization value in the annuity over a set number of years. For example: An owner-annuitant who is 60 years old may choose to annuitize his contract and elect to receive the benefits over a five year period which would end when he reaches age 65 and becomes eligible for Social Security and possibly benefits from retirement plans. Most companies offer the period certain option for any period from a few years to 25 or 30 years.

If Mrs. Black has an annuitization value in her non-qualified annuity of $200,000, decides to annuitize and elects the fixed period settlement option over a five year period, her monthly benefit might be about $3,664. She would receive this benefit payment each month for 60 months (5 years). At the end of this time, benefit payments to Mrs. Black would cease. No further funds would remain in the annuity contract and no further benefits would be payable. If Mrs. Black should die during the five year period, the benefit payments would continue to her beneficiary until the end of the five years.

Fixed Amount Annuity

Under this settlement option, the annuitant receives benefit payments of a set amount for as long as the annuity's annuitization value plus interest lasts. If Mrs. Black has an accumulation value of $200,000, under this settlement option she could elect to receive a monthly benefit payment of $3,000 (or any other amount she preferred). The insurance company would send her a check each month for as long as the accumulation value and interest would support the benefit. After the funds in the annuity were exhausted, Mrs. Black would not receive any further benefits from the annuity contract. In the event of Mrs. Black's death before the funds in the annuity have been used up, the remainder is generally paid to her beneficiary.

Interest Income

Although it is not a "settlement" option strictly speaking, many annuity contracts offer the option of leaving the accumulation value of the annuity with the insurance company. While the funds remain with it, the insurance company credits the funds with a current rate of interest. The individual can either take receipt of the interest amounts or allow them to continue to accumulate.

SURRENDER CHARGES

Most annuity contracts levy a "charge" against partial and full surrenders from the contract for a period of years after the annuity is purchased. This charge, usually referred to as a "surrender charge" or a "deferred sales charge," is intended to make it less attractive for annuity owners to move funds in and out of the annuity and to allow the insurance company to recover its costs if the contract does not remain in force over the long run.

The surrender charge is usually applicable to surrenders made from the annuity for a certain number of years. Although this period varies from one annuity to another, it usually runs anywhere between 5 and 10 years. The surrender charge is usually a percentage that is applied to the funds received as a result of the surrender. Typically, the surrender charge percentage decreases with each passing year. For example: A non-qualified annuity contract might provide the following surrender charge schedule:

Contract Year	Surrender/Withdrawal Charges
1	8%
2	7%
3	6%
4	5%
5	4%
6	3%
7	2%
8	1%

Thus, any surrender made in the fourth contract year under this schedule will incur a surrender charge under the contract of 5%. After the contract has been in force for 8 years, no surrender charge will apply.

If a Section 1035 exchange is being contemplated, it is important to keep in mind the fact that the contract surrender charge may be applicable to the originating contract. Although Internal Revenue Code Section 1035 will prevent current income taxation on the exchange of one annuity for another, the amount of the exchange may be less than the cash value of the originating contract due to surrender charges.

To illustrate in greater detail, assume that Mr. Smith makes a partial surrender of $10,000 from his annuity in a year in which the surrender charge is 5%. He will lose $500 (5% of $10,000) as a result of the surrender, effectively receiving only $9,500. Some insurance companies subtract the amount of the surrender charge from the amount actually paid to the contract holder, as illustrated with Mr. Smith. Most annuity contracts provide that, with a partial surrender, the surrender charge is applied against the values still remaining in the contract after the surrender. Thus, in this instance, Mr. Smith would receive a check for the full $10,000 partial surrender amount but a $500 charge would be levied against the funds remaining in his annuity. In the event of a full surrender, of course, the check sent to Mr. Smith would be reduced by the amount of the surrender charge.

The surrender charge schedule of most *flexible premium* deferred annuity contracts is fixed, such that surrender charges will no longer be applicable at the end of the specified number of years regardless of when premiums were paid. In other contracts, a “rolling surrender charge schedule” is used, where each recurring premium is subject to its own surrender charge schedule. For example, such a contract might impose a “rolling” 10 year surrender charge schedule where the most recent premium is subject to that 10 year schedule even if the contract has been in existence for several years. Typically, such contracts provide that any withdrawal is deemed to come from the oldest premium.

Most deferred annuity contracts provide that no surrender charge will be levied if the annuitant dies or becomes disabled. A few contracts do not waive surrender charges at death and a very few include surrender charges that never expire unless the contract is annuitized.

Having looked at how surrender charges are assessed under the annuity contract, it bears restating that this surrender charge is one that originates in the annuity contract itself. This “contract” surrender charge should not be confused with the 10% penalty tax that is applicable to premature withdrawals from annuities under the Internal Revenue Code. These two “penalties” or “charges” are often confused. This confusion is easy to understand since it is possible for a surrender from an annuity to be subject to both or only one of the contract surrender charge and the 10% penalty tax. It is also possible that a surrender of funds from an annuity will not be subject to either of these items since the penalty tax generally applies to distributions received prior to age 59 1/2 and the contract surrender charges apply during the first few years after the annuity is purchased.

To illustrate, assume that Mr. Black, age 65, purchased a deferred annuity two years ago. If he surrenders the contract this year, he will incur the third year contract surrender charge of 6% but he will not be subject to the Internal Revenue Code 10% penalty tax since he is older than age 59 1/2 at the time of the surrender. However, if Ms. White, age 44, surrenders a deferred annuity contract purchased 20 years ago, it is not likely that any contract surrender charges will still be applicable, but the Internal Revenue Code's 10% penalty will still apply since Ms. White is younger than age 59 1/2.

Surrender charges are often considered to be always a "drawback" to the attractiveness of a deferred annuity. This is not entirely fair. Insurance companies know that if the purchaser of an annuity or life insurance policy surrenders that contract shortly after purchase, the company will lose money. This is because all insurers experience "acquisition costs" including agent commissions, overhead expenses, and the necessity to set aside mandatory "reserves" to back the contract guarantees (which must be invested at very conservative rates). Every insurer knows that it will take time for the profit it experiences by investing premiums received to equal those acquisition costs. There are basically only three ways in which an insurer can recoup lost acquisition costs.

1. It can impose a front-end sales charge. Many older annuities included this charge but newer contracts generally do not as they have not been attractive to consumers.

2. It can credit a lower rate of interest than it would otherwise be able to credit and apply that difference toward acquisition costs. This method will clearly make an annuity contract less attractive than contracts offering a "normal" interest crediting rate.

3. It can recognize that any loss due to honor recouped acquisition costs is only created by those customers who surrender their contracts early and charge only those customers for that loss by imposing a surrender charge schedule which will eventually expire (when it has recouped acquisition costs). This method is often recognized as being the "fairest". Regrettably, all too many insurance agents fail to explain *why* surrender charges exist and that, absent those charges, the insurance company would not be able to offer competitive interest.

WITHDRAWALS

Partial Surrender

Almost all non-qualified annuity contracts permit the contract holder to make a surrender of a portion of the values accumulated in the annuity prior to the time that the annuity begins paying benefits. Some contracts limit the frequency with which partial surrenders may be made and some require that a minimum amount remain in the annuity after any surrender is made. For example: An annuity might allow only one partial surrender each contract year and might require that at least $5,000 remain after such a surrender. Some annuities require that the amount of the partial surrender be at least a certain minimum amount such as $100 or $500.

A myriad of tax legislation over the past fifteen years has complicated the taxation of a partial surrender from a non-qualified annuity. For now, it is sufficient to say that if the annuity was issued after August 13, 1982, a partial surrender will be taxed as income first and return of basis second. To illustrate this method of taxation assume that Mrs. White purchased an annuity for a single premium payment of $50,000. The value of the annuity today is $80,000, resulting in interest earned in the contract of $30,000 ($80,000 surrender value minus the $50,000 single premium). Mrs. White decides to make a partial surrender of $20,000. Under the interest first rule, Mrs. White will pay income tax on the full $20,000 received as a result of the partial surrender. This is true because amounts coming out of the annuity first are deemed to be interest, so until the partial surrender amount exceeds the interest in the annuity of $30,000, any partial surrender amount will be fully taxable.

Some annuity contracts will waive the contract surrender charge for a certain number of partial surrenders from the contract. A common number here is one per contract year. Even though the insurance company does not assess a surrender charge under the annuity contract, the 10% premature distribution penalty tax assessed under the Internal Revenue Code may still be applicable.

Full Surrender

An annuity can be surrendered in full at any time prior to the time it is annuitized and begins to make benefit payments. In addition to the income tax ramifications, contract surrender charges and income tax penalty taxes may be applicable.

After a full surrender, the annuity contract is no longer in existence and, of course, will not pay any benefits to the annuitant, owner, or beneficiary.

10% Per Year Withdrawal

Many annuities allow the contract holder to withdraw or make a partial surrender of an amount equal to 10% of the accumulation value each contract year without the contract surrender charges being applied. Usually this feature is not available until the second contract year. With some annuity contracts, this 10% is cumulative or, in other words, can be carried over from one contract year and added to the next year’s 10% amount.

For example: If an annuity holder makes a 10% surrender in the second year of the contract and then does not make any surrender in the third contract year, in the fourth contract year the annuity holder would be able to surrender as much as 20% of the annuity’s accumulation value without paying the contract surrender charges. Usually, there is a maximum amount, such as 50%, which may be accumulated.

The amount subject to withdrawal without the contract surrender charge being assessed is not 10% in all annuities. Some annuity contracts offer a choice of 10% or the earnings on the funds placed in the annuity. Others apply this free surrender provision to 10% of the contributions to the annuity in the past five or seven years. Still others apply the free surrender provision to something along the lines of the lesser of the accumulation value less premiums or 10% of the accumulation value.

It is good advice to read the details of an annuity contract’s free withdrawal provision before making such a surrender. The requirements vary from contract to contract and some companies credit a potentially lower rate of interest on funds that are surrendered out of the contract than they would credit if the funds remained in the contract.

Whatever the specifics of the free withdrawal provision, it does not release the contract holder from the income tax consequences, including the 10% premature distribution penalty tax.

Systematic Withdrawal Option

Many annuity contracts offer the contract holder a systematic withdrawal option as a way to take money out of the annuity contract during the accumulation phase. The annuity holder can elect to withdraw a set amount each month or each year without any contract fee or surrender charge being assessed. Usually, the contract holder can terminate or alter the systematic withdrawal option at any time. Under some annuity contracts, the annuity holder can make lump sum withdrawals from the annuity in addition to the withdrawals being made under the systematic withdrawal option.

Usually, there must be a minimum amount in the annuity before the systematic withdrawal option can be put into effect. Also, there is generally a limit on the amount that may be taken out of the annuity contract under the systematic withdrawal option each year. A typical provision limits the yearly withdrawals to 10% of the purchase payments.

As mentioned above, the fact that the insurance contract waives fees and surrender charges under the annuity contract does not alter the income tax consequences including the 10% premature distribution penalty.

Loans

Most non-qualified annuity contracts do not offer the option of taking a loan against the annuity values. This is probably due to the fact that any amount received as a loan under a contract entered into after August 13, 1982 is taxable to the extent that the cash value of the contract immediately before the loan exceeds the investment in the contract.