Chapter 11
Annuities

1. Designed to provide an income for life; or, if desired, for a shorter period of time; or
2. Can be used solely for accumulation of money on a tax-deferred basis (like a savings account)
3. After tax dollars invested; earns interest that is not taxed until taken out (tax deferred)

Two distinct periods

1. **Accumulation period –** when money is being deposited into account and earning interest or money just sitting there earning interest
2. **Annuity period –** the period when the annuity stops accumulating and begins paying monthly, quarterly, annual payments for life *(a note: the majority of annuities are never annuitized)*

Funding

- **Lump sum**
- **Periodic deposits** – monthly, quarterly, etc. (fixed or flexible)

Ways to take money out

- **Withdrawals (penalized if done before 59 ½); Taxed as L.I.F.O. –** *gains are taxed first*
- **Annuitized payments**
- **Loans –** Borrowing from company using money as collateral

Immediate annuities

- Always funded with a lump sum
- Designed to be begin annuitizing within 30 days (Single Premium Immediate Annuity)

Deferred Annuities

- Designed to begin payments in the future
- Can be funded with lump sum or periodic payments

Annuity payout options – chosen at time of annuitization, not at inception of annity

1. **Straight life** – pays the annuitant until death. No more payments, even if the full amount has not been paid out. Highest monthly payout. Most risk to annuitant.
2. **Cash Refund** - pays the annuitant until death. Balance to be paid to a beneficiary if total amount not paid out. Monthly check will be less to annuitant because of guarantee.
3. **Installment refund** – same as above but balance paid in installments
4. **Life with Period Certain** – guarantees to pay
   a. annuitant for life, or
   b. a guaranteed amount of time, whichever lasts the longest
5. **Joint & Survivor** – two annuitants, one check
   a. **Joint & ½** - survivor receives ½ the amount for life when 1st annuitant dies
   b. **Joint & 2/3** - survivor receives 2/3 the amount for life when 1st annuitant dies
6. Period Certain – does not pay for life..ex. the state lottery; pays maybe 30 years

Investigation Configuration

1. **Fixed annuities** –
   a. designed to pay fixed guaranteed payments to annuitant
   b. company invest money mostly in bonds
   c. company pays the current rate of interest but guarantees a minimum rate of return
   d. investment risk is on the company
   e. inflation could be a problem
   f. state regulated
2. **Variable annuities**
   a. Designed to off-set inflation
   b. Stated in terms of units
      i. **Accumulation units** – similar to buying shares in a mutual fund
      ii. **Annuity units** – <u>accumulation</u> units converted to <u>annuity</u> units when ready to annuitize; the <u>number</u> of units is fixed then, never changes; the <u>value</u> changes all the time
   c. Policyowner chooses from a wide choice of investments
   d. Policyowner assumes the investment risk
   e. State & federally (SEC) regulated; dually regulated;
   f. Must be registered with F.I.N.R.A. Financial Industry Regulatory Authority; Registered Representatives
   g. Sale must be preceded or accompanied by a prospectus
3. **Indexed annuities**
   a. Duration of seven year time periods (or three year, five year)
   b. Not designed to provide income (annuitized)
   c. Designed for tax deferred accumulation
   d. Invested in the S & P 500
   e. Ratcheting as an option: a guarantee that credited interest or increases in value will not be lost; locks in gains;

Taxation

- **Withdrawals**
    - If before 59 ½, 10% penalty
    - Last In First Out (LIFO); Gain comes out first;
    - Taxed at ordinary income rates, not capital gains
- **Annuity payments (annuitizing)**
    - Can <u>annuitize</u> at any age WITH-OUT <u>penalty</u>
    - Part of each payment represents <u>interest</u> and <u>is taxed</u>; part of each payment resents principal (cost) and is not taxed
    - <u>Exclusion ratio</u> = the % of each payment that EXCLUDED from taxes; The amount invested divvied by the expected return
    - IRS sends form 1099 each year telling what amount is taxed (saves the annuitant from doing math ☺)

1035 Exchange

- Allows policyowner to roll gains from an annuity to another annuity w/o being taxed
- Discussed in chapter 8

Qualified Annuities

- **403 B plans**
    - **For 510 C 3 organizations**
    - **For Teachers**
    - **Preachers**
    - **Rabbis**
- Contribution Limits similar to 401K (don't need to know the amount)
- Tax deductible contributions
- ALL the money will be taxed when taken out

Annuities may be used for <u>Structured Settlements</u>

- **Law suit awards**
- **State lotteries**