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## Annuity Basics and Terminology

At its most basic level, an annuity is simply a [contract](#) with an insurer that guarantees to provide payments to an owner. An annuity contract typically helps individuals accumulate money for retirement, and then provides an income stream to supplement other retirement income sources. Like life insurance, annuity contracts include guarantees that only insurance companies can provide. They are unique compared to other investment opportunities because of these guarantees.

A number of features make annuities attractive and well suited for retirement savings:

- Money is tax-deferred until withdrawn, allowing for potentially greater accumulation of contract value;
- Contracts include guaranteed death benefits payable to beneficiaries that ensure, at a minimum, that no less than original purchase payments are distributed;
- Contract owners can choose from payout choices that include a lump sum, periodic payments or a monthly income guaranteed for life;
- The Federal Tax Code includes a provision that permits the [transfer](#) of annuity contract values between annuities. This is helpful if financial objectives change.

### A. Annuity Categories

The process of making suitable recommendations to customers and ensuring their understanding of and satisfaction with an annuity purchase, is heavily dependent on education. Persons who are unfamiliar with annuities sometimes view them as complicated, with features and terminology that are obscure and hard to understand. To ensure that you can provide a simple explanation of how an annuity can benefit your customer, and why it is a suitable solution, you need a solid understanding of basic annuity terminology.

At a high level, the insurance industry categorizes annuities in two ways:

1. How purchase payments are made; or
2. When payments from the annuity begin.

Purchase payments can take the form of a single lump sum, or **single premium**. In other words, the purchase payment is a one-time only deposit that accumulates earnings until a defined date. Other contracts can receive payments on a predetermined, scheduled basis, such as annually, quarterly, or monthly, while still others are open for contributions at any time that the owner wishes to make them. Contracts that receive more than a single payment are **periodic payment** annuities.

At the time of annuity purchase, the owner makes the determination of when payments from the annuity will begin. If the owner has the need for income in the very

near future, and wants the income stream that the annuity generates to begin anywhere from 30 days to 12 months from the date of purchase, the owner must purchase an **immediate** annuity.

A **deferred annuity** is an annuity that either is purchased with a single lump sum (single premium-deferred annuities) or is purchased through periodic payments (flexible premium-deferred annuities). Deferred annuities are unique in that they grow tax deferred. **Deferred annuities are often used to accumulate funds for retirement.** In a deferred annuity the owner will receive the **current interest rate** or the **guaranteed interest rate**, whichever is higher. **Payments from a deferred annuity** begin later in the future sometime after one year from the date of purchase (10 years, 20 years, at age 65, etc.). This time is often consistent with retirement, but varies with the owner's situation and preference. If an annuity is tax-qualified, the annuitant is required to begin minimum required distributions by age 70 ½. Failure to take the required minimum distribution by age 70 ½ will result in a tax penalty. If the annuity is nonqualified, there is no requirement to withdraw the funds at any age except as required by the contract itself.

From these differences in the way annuities are purchased and how made payments are made, three basic annuity categories results. Purchasers of annuities may choose from

- Single premium immediate annuities;
- Single premium deferred annuities; and
- Flexible premium deferred annuities.

When individuals purchase annuities, the insurance company invests the purchase payments to generate earnings that add to the income contract owners ultimately receive. The method of investment and the amount of risk **exposure** that buyers assume further categorizes annuities as either fixed or variable. In fixed annuity contracts, the insurer assumes the investment risk, and promises the annuity owner a conservative rate of return based on a conservative investment portfolio. There is no risk of loss to the annuity owner, and they know exactly what their contracts are worth at all times. Variable annuity contracts offer a greater reward potential to investors, but with the tradeoff of assuming investment risk or potential loss of principal. The insurance company does not guarantee an amount of investment earnings, and they vary directly with market performance.

In combination with the previous categories we identified, we further subdivide annuities by the investment risk the purchaser assumes for 4 general categories:

1. Fixed immediate annuities;
2. Variable immediate annuities;
3. Fixed deferred annuities; and
4. Variable deferred annuities.

Next, we will discuss each category individually, with the objective of demonstrating situations in which they are suitable and customer needs that they serve.

Before we begin the deeper dive into these more specific descriptions, let's review general annuity terminology that applies overall.

## B. Annuity Definitions

Several groupings of annuity definitions follow to help you associate these terms appropriately within the annuity lifecycle. These terms will appear within the context

of our product discussions as we proceed through the course. Most annuity contracts include an explanation of some of these key terms to help the owner understand contract nuances specific to that insurer.

## 1. Contract Terminology

**Accumulation Phase** – the time during which an annuity owner can add money to the [contract](#). Also referred to as the growth period, it is the time between purchase of the annuity and the beginning of benefit payouts. Principal and earnings accumulate tax deferred during this period.

**Annuitization Phase** – the time when the insurer makes periodic payments to an annuitant, also known as the distribution period or payout period. Payments can cover a specified period or may be guaranteed for life. During this period, payments may be fixed or variable, and include earnings that are taxable to the annuitant.

**Annuitize** – the time at which the contract owner trades the accumulation value of the annuity for a stream of payments paid for a defined period of time or over the life of one or more annuitants.

**Annuitant** – the person whose life expectancy is used to calculate the income payment amount on the annuity. That is why the annuitant must be a natural person. The annuitant and the contract owner are usually the same individual.

**Annuity Owner** – the person(s) who have contract authority. The owner selects from investment options, designates beneficiaries, and may withdraw, surrender or change annuity benefits. The annuity owner often is the recipient of payments from the annuity in the annuitization phase.

**Joint Annuitant** – an individual in addition to and together with the annuitant, whose age and life expectancy determine the amount of the annuity payments.

**Joint Owner** – an individual who shares ownership of an annuity contract and possesses the same rights as the contract owner to approve any contract decisions.

**Maturity Date** – the latest date at which an annuity must be converted to income payments (or annuitized).

**Contract Anniversary** – the same day and month as the contract issue date for each year the contract remains in force.

**Contract Issue Date** – the [effective date](#) of the contract, which determines future contract years and contract anniversaries.

**Contract Year** – a 12-month period beginning any contract anniversary date.

**Free-Look Period** – An annuity contract provision that provides a period after contract issue for the owner to examine the annuity contract with the option of returning it to the insurer for a full refund (usually 10 to 30 days).

**Surrender** – the act of termination of an annuity contract by the owner. All accumulated interest is usually be taxable to the owner at time of surrender, and the IRS 10% tax penalty will apply if the owner is not yet 59½ years of age, unless an IRS exception applies.

**Surrender Value** – the amount of contract value available for withdrawals or for early termination. This value is reduced by applicable fees if the contract value is accessed in the early years of the contract.

**Surrender Charges** – charges imposed by the insurance company for withdrawal of contract value before the end of the surrender charge period. Surrender charges typically are a percentage of the total premium deposited, and decrease to zero over a period of years defined in the contract (often 5 – 10 years). Many companies allow an annual free withdrawal amount, such as 10% of contract value, annually during this period. A new surrender charge period may apply to each subsequent contribution.

**Premature Distributions** – also known as early or partial withdrawals, these occur prior during the accumulation phase of the annuity. Owners must report withdrawals as income and are subject to ordinary income tax treatment. If withdrawals are made prior to age 59½, they may be subject to an additional 10% federal income tax penalty. Insurer imposed surrender charges may also apply.

**Minimum Guaranteed Surrender Value (MGSV)** – the minimum value paid to the annuitant in the event of death, surrender, or low performing investments. The National Association of Insurance Commissioners (NAIC) has mandated that MGSVs on annuities cannot credit anything less than 1% interest on 87.5% of the premiums paid on the annuity. However, as much as 3% interest can be credited on 100% of the premiums paid on the annuity. There is a direct inverse correlation between the richness of the annuity's MGSV and the potential for gains on the contract; in other words, the higher the guaranteed minimum, the lower the potential investment gains credited to the contract.

**Rider** – an optional benefit, also called an [endorsement](#), that is added to a base annuity contract and changes the annuity's terms, features, or conditions.

**Settlement Options** – the methods by which the insurer may pay annuity proceeds to the annuitant, contract owner, policy owner or [beneficiary](#). The options are many and may include payout periods that guarantee income for life to one or two annuitants, beneficiary protection, or specified periods.

**Term certain option** – an annuity payout option, also known as a period certain or fixed period, that distributes income payments over a set number of years.

**Systematic Withdrawals** – payout strategy that allows withdrawals from the accumulated annuity contract value on a regular schedule. Flexible withdrawals are also permitted.

**Collateral Assignments** – the [transfer](#) of the ownership rights in the contract to another person to serve as collateral for debt. When this provision is invoked, there is typically another provision that reverts the ownership rights back to the original owner upon debt repayment. This is considered a taxable event to the owner of the contract.

**Proof of Death** – proof that may be required for payment of contract benefits, particularly death benefits. Acceptable proof may consist of a certified copy of the death record, a certified copy of a court decree reciting a finding of death or any other proof defined as satisfactory to the insurer.

**A.M. Best Rating** – an independent analysis of an insurer's financial strength and ability to meet its ongoing [insurance policy](#) and contract obligations, as provided by the firm A.M. Best.

## 2. Annuity Contributions and Interest Rate Terms

**General Account** – The insurance company portfolio used for the investment of purchase payments from fixed contracts. This portfolio is usually invested in safe,

conservative, guaranteed investments, such as government securities, real estate and mortgages.

**Separate Account** – The insurance company investment portfolio that supports variable annuities. It is kept separate from the insurance company's regular investment accounts and is invested more aggressively than the general account.

**Subaccounts** – The various investment portfolio options in which variable annuity payments are invested. The annuity owner chooses which subaccounts to invest in and how much to allocate to each.

**Simple Interest** – The interest crediting method in which interest is only credited on the principal payment, not on the interest accrued.

**Compound Interest** – The interest crediting method in which interest is credited on the principal payment, in addition to on the interest itself.

**Current Interest Rate** – The interest rate that an annuity is paying, including the sum of the base rate and the bonus rate, if any. The current rate is set by the insurance company at the time of contract issue and is guaranteed for specific length of time.

**Floor** – The minimum amount of interest credited to an annuity each year.

**Guarantee Period** – The period of years that an interest rate is guaranteed on a multi-year guaranteed annuity.

### 3. Annuity Features and Fees

**Death Benefits** - Payments made to beneficiaries or the annuity owner's estate if death occurs before the annuity matures. The benefit that is payable varies with the [contract](#), but is an important feature that differentiates annuities from other retirement savings alternatives.

**Surrender Charge Waiver** - A feature that permits the annuitant to withdraw a portion of the annuity value without the imposition of surrender charges in the event of certain triggers. These triggers vary by contract and can include death, disability, nursing home confinement, terminal illness, unemployment, and natural disaster.

**Return-of-Premium (ROP) Option** – This annuity feature guarantees a return of the full premiums paid in the [contract](#) to the annuity purchaser, at any time.

**Bailout Option** – This annuity contract provision allows the contract owner to surrender the contract without a surrender charge applying, if renewal interest rates or index cap rates fall below a pre-determined level. It is designed to alleviate concern of locking money away and giving up control.

**Administrative Fee** – An optional charge that covers the cost of issuing and maintaining the contract. These fees often apply to small contracts that are below an established purchase payment amount, and may be applied at the time of issue or on an annual basis.

**Mortality and expense risk charge (M&E)** – This fee covers the insurance guarantees included in an annuity contract, including the [death benefit](#), the choice of guaranteed lifetime payout options, and the guarantee that insurance charges will not increase.

**Recapture Charge** – A feature that applies to annuity contracts with premium bonuses, which causes a forfeit of all or a portion of the premium bonus in the event of withdrawal in excess of the penalty-free amount, during a specified period.

**Premium Tax** – a tax on annuity premium payments that some states impose on insurance companies.

**Market Value Adjustment (MVA)** – This feature is usually applicable to fixed deferred annuities, and is triggered when certain withdrawals are taken. If it is applicable, the MVA causes an increase or decrease to the withdrawal amount or the contract value of the annuity if more than the penalty-free amount is withdrawn or if the contract is surrendered during the surrender charge period.

**Exclusion Ratio** – This ratio applies to nonqualified contracts only, and determines which portion of an annuity distribution is considered earnings and which portion is a return of the original investment. The portion consisting of earnings is taxable as ordinary income to the annuitant. The portion that is considered a return of principal is not taxable.

## C. Parties to Annuity Contracts

An annuity [contract](#) involves interaction between four distinct parties. These parties are

- The owner;
- The annuitant;
- The beneficiary; and
- The issuing insurance company.

### 1. The Insurance Company

Several hundred U.S. insurance companies offer and issue annuity contracts to the public. In return for purchase payments, they assume a number of financial obligations to the other parties of the contract, the owner, the annuitant, and the [beneficiary](#). The insurance company that issues an annuity contract promises to invest the owner's purchase payments responsibly, credit interest to the contract value of the annuity, pay the settlement option selected by the contract owner, and pay death benefits to the beneficiary or beneficiaries at death.

It is a very important [consideration](#) in ensuring suitable annuity sales that the insurer that issues and backs the contract is financially strong. Many consumers rely on the ratings provided by independent organizations like A.M. Best, Standard & Poor's, and Moody's. These organizations issue ratings and opinions regarding the financial strength of the issuer after performing comprehensive quantitative and qualitative evaluations.

Even the most well-known insurance companies can be financially vulnerable – regardless of high ratings. Although the number of insurance company financial failures is very low, the fact that they have happened at all can be frightening to consumers. Similar to the FDIC in banking, insurance guaranty associations exist to protect state residents who own contracts or are beneficiaries of contracts issued by insurance companies that can no longer conduct business. All insurance companies licensed to write life and health insurance or annuities in a state are required to be members of the state's life and health insurance guaranty association. If there is a shortfall of funds needed to meet the obligations to policyholders, state guaranty associations cover legitimate claims from assessments collected from insurers doing business in that state. The amount insurers are assessed is based on the amount of premiums that they collect in that state. Like the FDIC, state guaranty associations have maximum benefit limits that vary from state to state, but virtually all states offer

at least \$100,000 to \$300,000 of coverage for individual annuities. Some states, including Washington and New York, have extended coverage amounts to \$500,000.

## 2. The Owner

The annuity **contract** owner is usually the person who purchases the annuity. As the term "owner" implies, the owner of an annuity contract holds certain rights under the contract, such as the right to make purchase payments, to withdraw part or all of the contract value, to terminate the contract, or change the parties to the contract, like the annuitant or **beneficiary**. The owner is usually a **natural person**, like an individual or couple, but can also be a non-natural person such as a trust or a partnership. Note that special tax rules apply to annuities owned by non-natural persons.

## 3. The Annuitant

The annuitant is the individual whose life expectancy determines the payments made from the **contract**. The annuitant **must be a natural person**, not a corporation or business entity. Insurers permit joint annuitants, which means that the payment calculation is based on two lives, and will continue until the second person is deceased. Most commonly, the annuity owner and the annuitant are the same person(s), although this arrangement is not required. Annuitants cannot make additional deposits, withdraw money or terminate the contract unless they are the owner.

## 4. The Beneficiary

All annuities have a **beneficiary** designation and frequently, insurance companies will not issue the **contract** until the beneficiary section of the **application** is completed. Insurers permit multiple beneficiaries as long as the total percentage of all beneficiaries equals 100%. The individual(s) or entity that is designated as beneficiary receives any death benefits that become payable under the annuity contract when another party to the annuity contract dies. Note that if an annuitant dies before annuitization, the beneficiary will receive either the amount paid into the plan or the cash value of the plan, whichever is greater.

The beneficiary has no rights under the annuity contract, other than the right to receive payment of the death benefit. The beneficiary cannot change the payout settlement option, alter the start date for benefit payments, and cannot make any withdrawals or partial surrenders against the contract. Annuity owners can also restrict the beneficiaries, meaning they can determine how benefits are paid at death. Some owners do not wish the beneficiaries to receive the account value in one lump sum and prefer to structure payouts over a period of time.

Unlike the party named as the annuitant there is no requirement that the beneficiary be a flesh-and-blood individual. Named beneficiaries often include trusts or other entities such as a charitable organization.



## D. Owner-driven vs. Annuitant-driven Annuity Contracts

Insurance companies choose to issue annuity contracts with certain features and specifications. One choice made by the insurer is whether to issue the annuity as an owner-driven or annuitant driven contract. What is the difference, and why is this important?

Annuitant-driven annuities are those that contractually pay a [death benefit](#) when the annuitant dies. At the death of the annuitant, the contract terminates and the insurer pays any death benefit to the contract's designated beneficiary. If the owner of an annuitant-driven contract dies, the annuitant receives the contract value and not the death benefit (unless the contract specifies otherwise). At the time of the owner's death, the account value may be less than the expected death benefit. In addition, the death of the owner can trigger tax consequences that may be undesirable, including the need to distribute all contract proceeds within 5 years.

If the owner and the annuitant are the same person, this distinction is generally not a material factor in planning. Increasingly, though, customers that purchase annuities prefer to name an annuitant other than themselves. In ensuring suitable sales, it becomes the agent's responsibility to explain the general difference between these types of contracts, and then help the client choose which type best suits the client's objectives. It is also important to direct the client to seek professional tax advice if necessary.

Annuitant-driven contracts are currently more common than owner-driven contracts; however, there are more and more owner-driven annuities. The subtle differences we have described can result in vastly different outcomes in contract execution and taxation.

Owner-driven annuities, on the other hand, pay a death benefit only when the owner of the contract dies. When the annuitant dies, the owner simply designates a new annuitant and the contract continues without interruption.

## Chapter Complete

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