

The Annuity Investment – What It Is & Doing It Right! by Paul M. League, QFP, CFP®
(see important risk and prospectus offering disclosures at the end of this article)

The Annuity Investment - "What it Is..."

Annuities are long-term investment contracts, issued and backed by insurance companies and designed as either "Fixed" or "Variable" rate, with the primary goal being long term savings.

"Fixed" rate annuities ("FA") offer a fixed rate of return, typically guaranteed for one year, and adjusted annually or more frequently depending on the timing of deposits or other company specific criteria. "Variable" rate annuities* ("VAs") offer investors a variety of investment options that generate "varying returns". VA sub-account investment options include conservative money market, fixed income, equities, diversified portfolios and in some cases with such accounts managed by large institutional money managers otherwise not accessible to the typical investor due to their otherwise large minimum investment requirements.

The key feature of Annuities lie in their tax deferral, and of the two types mentioned above, VA's offer a greater potential for asset growth through their investment sub-account options that are tied to market performance, and are best suited for long term investors who are not risk averse. VA investments "breathe with the market," meaning performance rises and falls under changing financial market conditions, with the exact weighting of invested dollars within the VA sub-accounts depending upon individual risk tolerance & investment objectives.

Annuities are not short-term investments and impose "penalties" for early surrender or distribution with 2 sources of penalties; namely:

1. Insurer product penalties (contingent deferred sales charges-CDSC), usually decline over a 1-15 year period; however, some offer a no surrender penalty feature.
2. IRS imposed penalties equal to 10% on "premature withdrawals/distributions" – i.e. those prior to Age 59 ½.

Of these two penalty sources only the 10% IRS penalty can be avoided under IRC Code Section 72(q) [and for qualified plans Code 72(t)]. This is done by taking equal distributions over a period of time not less than 5 years in duration and so long as that period of time takes one to the age of 59 ½. This IRS penalty is meant to prevent premature distributions and is understood as a kind of "balancing mechanism". 72(t) programs are complicated, and are not appropriate for all investors. It is recommended that investors seek the advice of a professional tax preparer prior to setting up distributions to determine suitability. Once established, changes or modifications to a 72(t) program may incur severe penalties from the IRS. 72(t) distributions from a qualified plan are still subject to normal taxation. Investors should note that distributions taken under a 72(t) program may be subject to surrender charges and/or early redemption fees based upon the type of investments held within the qualified plan. The intent of the Laws that allow for Annuity tax deferral is to encourage the public to invest for their futures, rather than overly depending on Social Security or other government programs, in return for the compounding advantages of tax deferral.

Annuities are generally not suitable as estate planning vehicles and are instead used for meeting living and retirement income needs. There is an exception with "Charitable Annuities" through CRT's, or Charitable Remainder Trusts, where one transfers highly appreciated assets out of an Estate to a Charity to reduce capital gains taxes. The Charitable Remainder Trust holds or sells assets until the death of the last income beneficiary with the remaining assets going to the Charity. During the life of "trust income beneficiaries" the annuity income provides the donor an income which donor's will often use to purchase Life Insurance, in a separate Life Insurance Trust (not part of the Charity), to create or expand an Estate upon the death of a donor on an income tax free basis.

Many use the Annuity as a kind of in life "cash bucket" to fulfill multiple needs, and retirement income needs. Yes, when assets are taken prior to age 59 ½, there is that potential 10% penalty (except in cases of disability, or on earnings on an investment made before 8/14/82, or as a part of a series of substantially equal periodic payments (SEPP) for life and not modified before age 59 ½ or within 60 months if modified after age 59 ½, or on payments made to a beneficiary or the annuitant's estate), but many feel the benefits of tax deferral far outweigh these concerns. It is important to note that withdrawals on investments made into Annuities issued after 8/13/1982 are treated as income first ["LIFO" ("Last In" being gains/interest, "First Out" being taxable as income)].

Another advantage offered in some Annuities can be found in "bonus" products that offer investors immediate credits of a percentage of purchase payments; however, there are often additional hidden charges that one must evaluate very carefully when considering such product features.

Annuities & Taxes

Annuities are different in how they are treated under tax law, and these differences are important to understand. First, let's consider the distinguishing "product features or contractual provisions" of annuities:

Annuities have certain features unique to them that, for an added fee, include death benefits and the aforementioned "bonus feature". Some annuities also offer "enhanced" death benefit protection features equal to the greater of the Annuity value, or the greater of 5% compounded annually or the largest Annuity value on any policy anniversary date prior to the owners death or their 81st birthday ("high water mark"), whichever is earlier, less any adjusted withdrawals. Often an Owner/Annuitant must be under Age 80 and must elect this enhancement at time of purchase. Typical costs for these enhanced benefits are .15 to .25 basis points added to the annual M & E (mortality & expense charges), based on asset value, and together total between 1.25% to 1.60%.

Additional features include (impose added annual fees and charges, including mortality, expense charges and a contract administration fee for these benefits):

- An array of payout options tailored to the needs of the contract holder, including the right to annuitize the accumulated value over a lifetime or a specified time period.
- A death benefit that is not subject to probate and often protects beneficiaries against market downturns prior to annuitization (all guarantees of an annuity are subject to the claims paying ability of the issuing insurer).
- The same tax-deferral on any gains that you get with other qualified plans but without the contribution limitations (contribution amounts are not tax deferred if withdrawals and other distributions are received prior to age 59 ½, and a 10% penalty may apply).
- The ability to transfer among funding options without creating a taxable event for the investor.
- A one-stop shopping approach that combines fixed income and stock/bond investment options in one account (most common in a "variable" annuity).
- Optional living benefit and death benefit features, which typically carry additional fees, can, in many cases, limit market risk (all guarantees of an annuity are subject to the claims paying ability of the issuing insurer).
- Through available fixed sub-account alternatives the potential exists to help reduce fluctuations in principle.

All investments have unique features, benefits and charges. Investors should discuss the suitability of any investment for their particular situation with a qualified investment professional.

Perhaps the greatest single distinction of an Annuity is that Annuities are insurance products whose gains, whether capital gains, dividends or interest, accumulate tax-deferred and are taxed as ordinary income when withdrawn.

An annuities' investment gains will accumulate tax deferred, and when earnings withdrawals are taken taxes are paid at ordinary income tax rates (withdrawals prior to age 59½ are subject to a 10% federal tax penalty; early withdrawals may be subject to charge; partial withdrawals may reduce contract benefits as well as the amount available upon a full surrender). With an annuity 100% of any gains are tax deferred until distribution, providing the potential for your money to stay fully invested to help grow your assets.

With annuities all appreciation is deferred and subsequently paid out under a more favorable annuitization "Exclusion Ratio", a formula that recognizes part of any annuity annuitization distribution to be a return of principle and therefore non-taxable. Certain annuities, those issued prior to 10/21/1979, benefit by a step-up-in-basis; however, if they are ever "1035 exchanged", they then lose this advantage.

Annuities are long-term investments and when purchased as a non-qualified investment, also give the freedom to continue the tax deferral advantage to and beyond the age 70½ mandatory withdrawal barrier of traditional IRA's & other qualified pension & retirement plans.

Proper Annuity Structuring Considerations – “Doing it Right!...”:

All deferred annuities come in two contract “forms”; namely, as Owner Driven (“OD”) or Annuitant Driven (“AD”), and by “driven” we mean that certain actions forcibly occur, by contract, upon death that are beyond the control of named parties to the contract, unless proper structuring is done regarding who is the Owner, the Annuitant and the Beneficiary to the contract. These “structuring issues” must be understood and addressed prior to anyone investing in an annuity. So, to begin, one must first understand the type of contract being used to make the investment and then proceed cautiously from there:

Owner Driven (“OD”) Owner(s) have all legal rights, and can change, as needed, the designated Annuitant, as the contract specifies, without any negative tax or penalties. Pays out only on the death of an Owner.

Annuitant Driven (“AD”) contracts dictate Owner(s) can usually be changed and are contract specific as to whether or not an Annuitant can be changed once the contract is issued AND, upon the death of either Owner(s) OR Annuitant(s), the contract will pay out.

[Note: In either form of contract, changes to beneficiaries (primary or contingent), may always be made.]

Before proceeding further we must also understand two important Rules that directly impact matters of proper annuity contract construction, or structuring, specifically surrounding the event of death:

“Death of the Holder Rule” which states that upon the death of a “Holder” (synonymous with the “taxpayer/Owner” in any contract, or, in the case of a non-natural Trust-Owner the Annuitant is considered the “Owner”, but only for death distributions), death benefits of the annuity MUST & WILL BE PAID OUT (this was enacted on contracts issued after 1/18/1985 by the IRS so as to prevent generational tax skipping and later became applicable to “any holder” after 4/22/87).

“Spousal Continuation Rule” [IRC 72(s)] which states that a surviving Spouse of a deceased Owner has the option of then becoming the Contract Owner and said Spouse can then continue the contract throughout his or her life and is therefore not forced to take a distribution (note that not all Insurance annuity contracts offer the Spousal Continuation Provision). If anyone else is named as a Primary Beneficiary, along with the Spouse, then the option of becoming the Contract Owner & continuing is usually lost (some companies, in cases where a Child and Spouse are named as “primary beneficiaries”, will allow Spousal Continuation on that Spouse’s remaining portion of the contract). IRC states only that the beneficiary be a Spouse; however, some contracts specify that the Spousal Election letter will only be sent out if the surviving Spouse is the sole beneficiary, which is a narrower interpretation of the Internal Revenue Code (“IRC”).

“Death Benefits” can come in two forms; namely, the assets that have accumulated in the annuity investment itself or, if the policy offers this feature and it is purchased, “enhanced death benefits”, which may give an even greater payout based on certain contract guarantees as noted earlier. The “enhanced death benefits” feature is another plus over many other types of investments. A key, however, to death benefit payouts in the two policy forms we are discussing, is to know on whose life the “enhanced benefits” are actually based; namely, is it the Owner or the Annuitant that triggers the “enhancement”?

In an OD contract death benefits are based upon the death of the Owner (i.e. “Owner Driven”), whereas in AD contracts they are instead based upon the Annuitant (i.e. “Annuitant Driven”). What is interesting in the case of AD contract forms is that distributions will occur [on Owners death as “distributions of annuity assets”, and on Annuitants death as “death benefits” (enhanced or not)] when EITHER the “Owner” or the “Annuitant” dies, which could bring about adverse income tax, gift tax, and premature distribution penalties to other named parties to the annuity contract (see examples herein below).

Yet another “adverse outcome” can occur for Spouses with improper designation of Beneficiaries. A special flexibility on death benefits exists for Spouses of Owner(s) in the “Spousal Continuation Rule” noted above. This Rule gives a surviving Spouse, of a deceased Owner only, the right to continue to build a tax deferred asset for heirs. The surviving Spouse, therefore, is not forced to take any assets until so desired. This Rule is, then, a meaningful exception to the “Death of the Holder Rule” noted above. Problems can and do arise when one names multiple, “primary” beneficiaries, or primary beneficiaries other than solely a Spouse.

Why is any of this of interest or importance to either investors or advisors? Well, in the typical husband & wife annuity investor scenario, Spouses are generally looking to continue the investment until after the second Spouse dies in order to pass remaining assets onto their children. Without correct contract structuring serious problems can occur that can negatively impact the parties to the contract. If structured correctly, however, one can avoid the four main pitfalls of poor annuity structuring brought about by death; namely:

1. untimely income taxation
2. unwanted gift taxes
3. the 10% IRS penalty, and a fourth pitfall...
4. loss of the Spousal Right of Continuation.

Let's look at the following identical structuring examples under the two different contract forms, Owner Driven (OD) and Annuitant Driven (AD), to see some of the problems that can and should be avoided when constructing Owner, Annuitant or Beneficiary contractual designations. As you will see, proper structuring is critical to the parties of an annuity contract.

Seemingly Simple and Benign, but Problematic Spousal Structure Example:

AD (Annuitant Driven Contract Form)

| | |
|-------------|-----------------------------------------------------|
| Owner | Husband |
| Annuitant | Wife (also considered a "Holder" in an AD Contract) |
| Beneficiary | Husband & Wife |

In the above "AD" contract example, were the Wife (Annuitant) to die first, the Husband becomes the sole beneficiary BUT cannot continue the annuity under the "Spousal Continuation Rule" noted earlier because there will have been no DECEASED Owner Spouse! (i.e. the only Owner is the Husband, and he continues to live; therefore, distributions will be forced upon him as the sole remaining and surviving beneficiary upon the death of the Wife).

Typical Faulty Family Structure Example:

OD (Owner Driven Contract Form)

| | |
|-------------|----------------------------------|
| Owner | Husband (Age 60) & Wife (Age 50) |
| Annuitant | Wife |
| Beneficiary | Kids |

AD (Annuitant Driven Contract Form)

| | |
|-------------|----------------|
| Owner | Husband & Wife |
| Annuitant | Wife |
| Beneficiary | Kids |

· Problem 1: In the above example, under the AD contract, if the wife pre-deceases her husband, the kids will get the payout. While this may look fine, it is not, because the surviving Husband/Owner lives and is therefore subject to having made a lifetime gift to the children (he, after all, "owned" 50% of the annuity), which creates adverse gift tax consequences, in the year of the death, to that Spouse (i.e. like a reduction to the exemption equivalent). The kids, if under age 59½, are also liable for the 10% penalty tax as well as ordinary income tax on any future income paid out of the contract because upon the death of the Annuitant the beneficiary(ies) become the "taxpayer", not the Owner!

· Problem 2: In the AD contract when the Annuitant-Wife dies the surviving Owner-Spouse is considered to have made a gift, to the beneficiaries (the Kids in these cases), and income taxes become due. Gifts between Spouses, however, are not subject to gift or income taxes. In contracts where a non-spousal Joint Owner dies the surviving Owner still maintains all "Owner rights" over that contract and under the "Death of the Holder Rule" becomes immediately subject to income taxes on any gain in the contract. (Note: In an AD contract, if there were not Joint Owners, as in the above example, upon the death of the Annuitant-Wife there would be the 10% premature withdrawal penalty on the Owner-Husband IF he were under 59 ½ at the time of the Annuitants death).

· Problem 3: The children, not the surviving Spouse, are now in full control of the assets!

· Problem 4: Since a Spouse was not made the sole primary beneficiary, the surviving Spouse loses the "Spousal Continuation Rule" right of continuation. Alternatively, in a jointly owned contract between Spouses, one could name the beneficiary as "joint survivor Owner" and thereby not lose the Spousal continuation option.

· Problem 5: Finally, by instead naming any kids as "Contingent Beneficiaries", the remaining assets would also avoid probate.

Are there remedies or corrective actions that can be taken to fix aberrant annuity structures such as the above? Yes, but it is not an easy "road to hoe". If you have an AD or OD contract with improper structuring, you may want to consider cashing out of it during a down market where your principal is very close to your policy value so that there is minimal if any tax consequences (non-IRA's). Using SEPP (substantially equal periodic payment payout options), under the first of the 3 available Methods (Annuitization, Amortization or Minimum Distribution), can effectively stretch out payments thereby lowering any due taxes, remembering, too, that the aforementioned "Exclusion Ratio" exclusively applies on payments made under the first of these three Methods; namely, the Annuitization Method only (see bottom of this article for important risk disclosures).

Some advisors may recommend a 1035 exchange of contracts; however, a requirement of the Law is that exchanges must be like for like structuring. Use of the 1035 exchange is generally not advisable on contracts where there was a step-up-in-basis before 10/21/1979, but would be acceptable on contracts pre 8/14/1982 since these are grandfathered, such that withdrawals from these contracts are taxed as "return of basis first" and then income-"FIFO" ("First In" principle, "First Out" non-taxable principle). Bearing in mind these contract dates, if you had an AD contract with an undesirable Annuitant designation, then you could 1035 exchange it for an OD contract that has the same Owner & Annuitant designation, and after contract issue you would then be able to correct the structuring of the Annuitant, since in an OD contract the Owner can (depending on the specific Insurance Companies contract) change a "faulty" Annuitant. One can employ other strategies, but clearly the best course is to structure the contract properly from the outset!

When "structuring" an annuity always structure it in a manner that can result in the least amount of negative tax and penalties upon payout of the death benefit, AND with the maximum amount of flexibility regarding those payouts. There are a maximum of 4 pay out options upon the "Death of the Holder/Owner" (these are not to be confused with contract "Annuitization Options"); namely:

1. Lump sum within 60-days of death (insurer contract specific)
2. 5 Year Rule-all money must be out of the contract at the end of 5 years (Code 72 Rule)
3. Annuitize over the Life Expectancy, but make the decision within 1-year (insurer contract specific)-several options exist under this category, like 10-year certain, etc.
4. Spousal Continuation of contract over the lifetime of the surviving spouse (Code 72 Rule)

[NOTE: death benefits/distributions paid out on the death of the Taxpayer/Owner result in an exception to the 10% pre age 59 ½ IRS penalty, but the same is not the case on the death of an Annuitant. Remember, appreciation to remaining contract assets over the 5 years is not treated as death benefits; therefore, net gains are taxable, in the year earned, and also subject the Taxpayer/Beneficiary, if under 59 ½, to the 10% pre age 59 ½ IRS tax penalty].

Always preserve not only the first three, but also most importantly the fourth of these; namely, the Spouses Right of Continuation, so that you achieve the maximum pay out flexibility in structuring your annuity. The best way to keep this flexibility is to name one or the other Spouse as sole beneficiary, or, conversely, in the case of joint ownership of the annuity (as in our first example herein), title the beneficiary designation as the "surviving Spousal Owner". If there are children they should be named as "contingent beneficiaries", since this can also preserve for them three of the above first four options upon the death of the last Spouse.

Preferred Family Structure Example:

OD (Owner Driven Contract Form)

| | |
|-------------|---------|
| Owner | Husband |
| Annuitant | Husband |
| Beneficiary | Wife |
| Contingent | Kid(s) |

AD (Annuitant Driven Contract Form)

| | |
|-------------|---------|
| Owner | Husband |
| Annuitant | Husband |
| Beneficiary | Wife |
| Contingent | Kid(s) |

Here, if the Wife dies first the Husband simply names new beneficiaries (likely the kids) and he thus maintains control over the asset. If the Husband dies first the Wife gets the asset and can continue the tax-deferral (i.e. she is not forced to take distributions) and the children may ultimately receive an even larger asset. Note, under this structure, all of the 4 negative pitfalls, under either an OD or AD contract, are avoided!

One problem for some clients is their objection to making one or another Spouse the sole "Owner". It is, however, best to name the older of the two Spouses as the Owner, or in AD contracts both the Owner & Annuitant should be the same, based on the reasonable assumption that the older Spouse is likely to die sooner. Justification for this is found in Mortality Tables that show that the number of years a same aged female is likely to live beyond a same aged male is only about 2-4 years (ages 50-85), but as the spread in age differences increases the likelihood of the older Spouse dying first is statistically much higher (doubled with a 10 year difference in ages where the younger Spouse is the female). A practical solution for Spousal ownership objections like this is to simply buy 2 separate contracts, one on each Spouse.

Finally, many designate Trusts as beneficiaries or even contingent beneficiaries of an annuity. First, there is no need to do this because annuities pass probate free. Second, Trusts do not allow for any form of Spousal Continuation nor "Lifetime Annuitization" due to their being a "non-natural person" (see "Non-natural Person Rule" that applies to contributions into annuities after 2/28/1986). Third, Trusts limit pay out options to only the first two options listed above; hence, a 50% reduction in pay out flexibility, which impedes income tax efficiencies on what otherwise could be "stretched out", lesser taxed, distributions. When making a Trust the Owner, especially in Revocable Trusts ("Living Trusts") where there are Spouses, it is important to know whether or not the Insurance Company issuing the annuity views the Trust as either a "natural or non-natural person" since, if they view the Owner-TRUST as a "non-natural person Trust", then they will not allow for Spousal Continuation; hence, another problem with making a Trust the Owner of an annuity.

There are no "look through provisions" on non-qualified annuities (i.e. wherein they will "look through" the Grantor/Trustee designation and recognize the Spouse and Spousal continuation rights). Look through provisions apply only to IRS provided rationale for IRAs/qualified plans when a Trust is the Beneficiary. When using a Trust as any part of an annuity structure, one should proceed very carefully. Agents are well advised to require and obtain a written letter of instruction from the clients attorney on exactly how he and the client want the structuring set up under an annuity contract.

Annuities have many advantages, and to achieve their fullest potential, they must also be properly structured.

Important Risk Disclosures: The contents of this article are not intended to be a substitute for individual tax, legal or for financial planning advice. Investors should obtain professional advice before making any changes to their policies or investments.

Annuity Disclosures:

An Annuity is a long-term investment vehicles designed largely for asset accumulation and retirement needs.

Annuities generally contain fees and charges which include, but are not limited to, mortality and expense risk charges, sales and surrender charges, administrative fees and charges, for optional benefits and riders.

Withdrawals and death benefits are subject to income tax. If withdrawals and other distributions are received prior to age 59 ½, a 10% penalty may apply. Annuities typically carry surrender charges for several years that may be assessed against withdrawals.

Certain annuity product features, offered by some annuity companies, such as stepped-up death benefit, a bonus credit and a guaranteed minimum income benefit, carry added fees.

Investments in the sub-accounts of a variable annuity are subject to market fluctuation, investment risk and possible loss of principal. An investment in the securities underlying a variable annuity involves risk, including the possible loss of principal. The contract when redeemed may be worth more or less than the total amount invested. An investment in a variable annuity is not guaranteed or endorsed by any bank, is not a deposit or obligation of any bank and is not federally insured by the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board or any other federal government agency. The purchase of a variable annuity is not required for and is not a term of the provision of any banking service or activity. When redeemed an investor's values may be worth more or less than the original price paid. Partial withdrawals may also reduce benefits available under the contract as well as the amount available upon a full surrender.

If you are investing in a variable annuity through a tax-advantaged plan such as an IRA, you will get no added tax advantage. Under these circumstances you should only consider buying a variable annuity if it makes sense because of the annuities other features, such as lifetime income payments and death benefit protection.

All guarantees of an annuity are backed by the claims paying ability of the issuing insurer and do not apply to the investment performance or safety of the investment options.

Prospectus Offering Disclosure: Investors should carefully consider the investment objectives, risks, charges and expenses of variable annuities and the underlying funds before investing. This and other information can be found in the prospectus for the variable annuity and the underlying funds, which can be obtained by calling 800.482.5347. Please read them carefully before you invest.

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