

## FEDERATION OF REGULATORY COUNSEL, INC.

# ANNUITIES: WHAT ARE THEY AND HOW ARE THEY USED

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1 An annuity is a contract under which the owner of the contract pays money or transfers assets to the obligor in exchange for the obligor's promise to make periodic payments to an annuitant.<sup>2</sup>

The three basic types of annuities are (i) commercial annuities issued by insurance companies in exchange for premiums, (ii) charitable annuities issued by qualified charitable organizations<sup>3</sup> in exchange for charitable gifts<sup>4</sup>, and (iii) private annuities created by an agreement between a transferor and a non-life insurance company which provide for the transferor to transfer property to the transferee in exchange for the transferee's promise to make scheduled payments to the transferor.

### **Commercial Annuities**

The three principal types of commercial annuities are (i) fixed annuities, (ii) variable annuities, and (iii) equity-indexed annuities. The period during which premiums are paid for an annuity is called the "accumulation period," and the period during which periodic payments are made to the annuitant is called the "payout period."

Fixed Annuities. Fixed annuities guarantee the payment of both interest and principal.<sup>5</sup> Premiums paid on an annuity contract are invested by the insurer in its general account.<sup>6</sup> Therefore, the value of a fixed annuity is dependent on the financial health of the insurer that issues the annuity.

The amount of each periodic payment is dependent on the amount of accumulated principal, the rate of interest applied to the principal amount, and the length of the payout period.<sup>7</sup> The rate of interest paid by the insurer on a particular annuity contract may be reset from time to time, but it can never be less than the minimum rate specified in the annuity contract. The payout period may be for the life of the annuitant or for a specified number of years, whichever is longer. It may also be for joint lives and for the life of the survivor.

Immediate annuities provide for a single (lump sum) premium, with the payout period commencing shortly after the payment of the premium.<sup>8</sup> Deferred annuities provide for the premiums to be paid in installments which may be flexible in amount and timing with the payout period being deferred until the end of the accumulation period.

Depending on how a particular annuity is structured, the premium may include fees to cover various charges, such as charges for mortality and expenses, and for riders and any special features included in the annuity contract.

Annuities are not suitable for short-term goals. They are designed to supply funds to meet long-term goals, such as retirement, and may be used to supplement social security and as a substitute for or to supplement pension plans offered by employers.<sup>9</sup> When tax qualified plans such as IRAs and 401Ks have been fully funded, annuities offer an additional vehicle in which to invest retirement assets. Fixed annuities may also be used as structured settlements to compensate individuals for injury.

Fixed annuities are regulated by state insurance regulators, and are sold by licensed insurance producers who may be independent or captive agents, or employees or associates of banks, brokerage firms and investment advisors.

Fixed annuities are tax-deferred. No taxes are paid by the annuitant on the interest earned on the principal until periodic payments are received unless the annuitant makes an early withdrawal. When periodic payments

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are made to the annuitant, the portion of the payments representing the interest earned on the principal amount paid by the annuitant with after-tax dollars is taxed as ordinary income.

Monies withdrawn from an annuity prior to the annuitant reaching the age of 59 and ½ years may be subject to a penalty tax if the withdrawal is not caused by the death or disability of the annuitant. If the monies are withdrawn during the accumulation period, they will be subject to immediate taxation and may also be subject to a surrender charge.<sup>10</sup>

If the annuitant of a deferred annuity dies during the accumulation period, the annuitant's beneficiary may elect to receive the entire principal and accrued interest in lump-sum<sup>11</sup> or in periodic payments over the life expectancy of the beneficiary.<sup>12</sup> If the beneficiary is a spouse, the spouse may continue the annuity contract in the spouse's name.<sup>13</sup> If the annuitant dies during the payout period, the beneficiary must receive the remaining portion of the annuity at least as rapidly as the method of distribution in effect at the annuitant's death.<sup>14</sup>

For estate tax purposes, death benefits payable on an annuity are included in the annuitant's estate to the same extent death benefits payable on a life insurance policy are included. Also, an annuitant's gross estate includes the value of the annuity or other payments receivable by a beneficiary to the extent the payments were payable to the annuitant.<sup>15</sup>

Variable and Equity Indexed Annuities. Variable annuities are essentially mutual funds wrapped in an annuity contract. Neither variable nor equity-indexed annuities guarantee the amount of periodic payments. Variable annuity periodic payments are based on the investment performance of the underlying mutual funds, and equity-indexed annuity payments are based on the performance of the equity index (e.g., Standard and Poor's 500 or the Wilshire 4500, etc.) chosen by the annuitant.

Variable annuities claim to combine the best aspects of fixed annuities (tax deferral, insurance protection for beneficiaries, tax-timing controlled income options) with the benefits of traditional mutual fund portfolios (flexibility in selecting how to invest funds and the potential for higher investment returns).<sup>16</sup>

Variable annuities may be immediate or deferred. Variable annuitants direct the investment of the accumulated principal amount in sub-account portfolios of stocks, bonds or money market funds. These investments may be managed by the insurer or a mutual fund company. However, unlike a mutual fund, a variable annuity does not pay out earnings or distribute capital gains. Instead, they are compounded on a tax-deferred basis.<sup>17</sup>

Most insurers that sell variable annuities offer 5 to 35 sub-account investment options, and an annuitant may make exchanges within those sub-accounts without sales or transfer charges.<sup>18</sup>

Variable and equity-index annuities are taxed in the same manner that fixed annuities are taxed for both income and estate tax purposes. When periodic payments are made on variable and equity-indexed annuities, only the portion of the payments that represent investment or index gains are taxed as ordinary income.

Fees included in the premiums for variable annuities include the costs incurred by the insurer in investing the premiums in the mutual fund or funds selected by the annuitant.<sup>19</sup>

Section 3 (a) (8) of the Securities Act of 1933 (the "Act") exempts from the registration provisions of the Act, "Any insurance or endowment policy or annuity contract or optional annuity contract issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or an agency or officer performing like functions, or any state or territory of the United States or the District of Columbia." However, Rule 151<sup>20</sup> under the Act provides that Section 3 (a) (8) does not apply to an annuity or optional annuity contract if the contract is marketed primarily as an investment, and the insurer does not assume the investment

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risk under the contract. For Section 3(a) (8) to apply, the value of the contract cannot vary according to the investment risk of a separate account.

Because variable annuities are a combination of insurance and securities and their value varies with the investment experience of a separate account, they are regulated by state insurance regulators, by the Securities and Exchange Commission, and by some, but not all, state securities regulators.<sup>21</sup> Equity-index annuities are hybrid fixed-variable annuities, and depending on how they are structured and sold they may or may not be deemed to be securities subject to the regulation of federal and state securities regulators.

Variable annuities are sold by persons who are licensed both as insurance producers and security salesmen. Such persons may be independent or captive agents or persons who are employees of or are associated with banks, brokerage firms and investment advisors.

### **Charitable Annuities**

Charitable gifts made in exchange for annuities may be made directly to the charity or indirectly through a charitable annuity trust.

**Charitable Gift Annuities.** A charitable gift annuity is a contract between a donor and a qualified charitable organization (a "charity") in which the donor transfers assets to the charity in exchange for a fixed annuity usually payable for the donor's lifetime. The donor is entitled to a charitable deduction in an amount equal to the difference between the value of the gifted assets and the value of the annuity. If the value of the gifted assets exceeds the donor's tax basis in the assets, the gain is taxable to the annuitant, pro rata, over the annuitant's life expectancy. Thus, each periodic payment received by the donor will be partly a non-taxable return of capital, partly taxable income, and possibly partly capital gain.

**Charitable Remainder Annuity Trusts.** A charitable remainder annuity trust issues a fixed annuity to the grantor, or to the grantor's beneficiary, in exchange for assets placed in the trust, and a charity named in the trust receives a remainder interest in the gifted assets. The trust grantor is entitled to a charitable tax deduction equal in amount to the value of the remainder interest. The annuity paid to the grantor or to the grantor's beneficiary is taxed in the same manner as annuitants of charitable gift annuities are taxed.<sup>22</sup>

### **Private Annuities**

A private annuity occurs when a transferor (the "annuitant") transfers assets to a person who is not an insurance company (the "obligor") in exchange for the obligor's agreement to make periodic unsecured payments (an "annuity") for the annuitant's life. A private annuity has many advantages, and is often used as an estate planning tool. If the value of the annuity is more than the value of the transferred assets, the annuitant will realize a capital gain which will be taxed to the annuitant pro rata over the annuitant's lifetime. If the value of the annuity is less than the value of the transferred assets, the difference will be subject to gift taxes. Upon the death of the annuitant, neither the transferred assets nor the value of the annuity will be included in the annuitant's taxable estate. However, the obligor's tax basis in the transferred assets will only be equal to the value of the periodic payments that are made prior to the annuitant's death. Each periodic payment received by the annuitant will be partly a non-taxable return of capital, partly taxable income, and possibly partly capital gain.

### **Conclusion**

Annuities are very useful products. They come in many forms, can be structured to serve many purposes, and provide numerous tax benefits to the parties involved. Life insurance companies annually write millions of dollars of fixed and variable annuity premiums. Charities rely on the use of charitable annuities to induce

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wealthy donors to make charitable gifts, and estate planners utilize private annuities to reduce estate taxes.

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### Endnotes

1. This article is limited in scope because a thorough discussion of annuities would require a book-long treatise.
2. The owner may be the annuitant or the owner may designate another person or persons as annuitants. For the purpose of this article, the annuitant is deemed to be the owner.
3. A qualified charitable organization is a charity that is eligible to receive tax deductible gifts from donors.
4. The insurance codes of all or substantially all of the states authorize qualified charitable organizations to issue annuities in exchange for the transfer of assets to the charity.
5. The principal is the sum of the premiums paid on the annuity contract net of the charges and fees imposed by the insurer.
6. In special circumstances the premiums may be invested by an insurer in a separate account created for such purpose.
7. At least for the number of years required for the annuitant to reach the age of 59 and ½.
8. Usually within 30 days.
9. Some major life insurers offer annuities designed to serve personal pension plans and have designed various features, such as inflation protection and interest rate protection, to make the annuities more attractive to purchasers.
10. Surrender charges usually start at around 6-8% and gradually decline over a period of years.
11. IRC Sec. 72 (s) (1) (B).
12. IRC Sec. 72 (s) (2) (B).
13. IRC Sec. 72 (s) (3).
14. IRC Sec. 72 (s) (1) (A).
15. IRC Sec. 2039 (a).
16. M. Lane, *Guaranteed Income for Life*, Mc Graw Hill (1999).
17. *Id* at 4.
18. *Id* at 9.
19. Such costs may include administrative fees, advisory fees, distribution fees, and front and back end commission loads.

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20. Rule 151 under the Securities Act of 1933 provides in part:
1. "Any annuity contract or optional annuity contract (a "contract") shall be deemed to be within the provisions of section 3(a)(8) of the Securities Act of 1933, Provided, That
    1. The annuity or optional contract is issued by a corporation (the "insurer") subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;
    2. The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this rule; and
    3. The contract is not marketed primarily as an investment.
  2. The insurer shall be deemed to assume the investment risk under the contract if:
    1. The value of the contract does not vary according to the investment experience of a separate account;
    2. The insurer for the life of the contract
      1. Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and
      2. Credits a specified rate of interest (as defined in paragraph (c) of this rule) to net purchase payments and interest credited thereto; and
    3. The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b) (2) (ii) will not be modified more frequently than once per year."
21. The National Conference of Commissioners on Uniform State Law adopted the Model Uniform Securities Act of 2002, but very few jurisdictions have adopted it. One of the reasons that more jurisdictions have not adopted the 2002 Model Securities Act is the uncertainty of whether its definition of a security should or should not include fixed and/or variable annuities.
22. IRC Sec. 664.