Annuities

This Dog Has Ticks and Fleas or

Is It just High Fees?

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What is an Annuity?

- Contract between you and an insurance carrier-typically a long term investment contract
- Insurer agrees to make periodic payments to you
- Premium payments can made in lump sum or in installments
- Distributions to annuitant can begin immediately or at a later date

Definitions

- **Immediate annuity**: Pay a lump sum in exchange for receiving income for a set period of time **or** for as long as you live.

- **Deferred annuity:** Generally is considered a long term retirement vehicle which builds savings on a tax deferred basis.

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Definitions

- Distributions triggered by annuitant's death

  A contract *does not* qualify as an annuity unless it provides that:

1. If annuitant dies on or after annuity start date, remaining proceeds must be distributed at least as rapidly as distribution method used at date of death
2. If annuitant dies before annuity start date, entire interest must be distributed within five years of date of death

(source: IRC Code Sec 72 (s)(1)

Investment options

- **Fixed annuity:** This provides a stable, guaranteed rate of return.

- **Variable annuity:** Annuity is invested in the stock or bond market or both and returns vary with the level of risk, fees and performance of the mutual funds

Tax Deferred Fixed Annuities

- “Guaranteed Rate of Return”-guaranteed by the insurance company.
- Short to intermediate return-typical range is 3 to 10 years. Current yields are 4% + -

Tax-Deferred Variable Annuities

- Benefit (lose) from market gains and losses
- Wide range of investment options including stock and bond funds. Rates of returns are dependent on expenses and performance of underlying mutual funds.
- Fund in lump sum, periodic payments or transfer from existing annuity (IRC 1035)

IRC 1035

- Allows you to exchange an existing annuity contract for a new one without paying income tax on the investment gains
- **Caution!**-exchanging from one insurance company to another may trigger a surrender charge from the old insurance contract

Tax Treatment of Annuity Payments

- Part of each payment is tax free as recovery of principal and the balance is taxable ordinary income

  Exception: If the start date was prior to 1987 there is an unlimited use of exclusion ratio (lifetime exclusion ratio)

- Fixed-excludable portion is found by dividing the investment in contract by the total expected return.
- Variable-excludable portion is found dividing the investment in the contract by the expected number of payments. (source: IRC Reg. 1.72-2(b)(3)

Tax Treatment of Annuity Payments

- If death occurs before basis has been recovered, the unrecovered portion is deductible on final return IRC Sec. 72 (b) (3) (A), and the deduction is "off the top" and can generate an NOL IRC Sec. 72 (b) (3) (C)
- Beneficiaries report annuity income at same ratio as decedent-no step up in basis at date of death

Tax Treatment of Annuity Payments

Impact on taxation of Social Security

Annuity income is includable in Modified Adjusted Gross Income

Result: higher taxable income may cause some portion of Social Security to be taxed

Advantages of Annuities

- Tax deferral
- Asset protection
- Guarantee of fixed annuities by the issuer

- Income tax deferred until withdrawals
- Annuities are insurance products generally protected from claims of creditors (however, distributions may be garnished)
- Guarantee is only as strong as the issuer (insurance company)

Advantages of Annuities

- Periodic Payments
  - Normally for the rest of your life, or the life of your spouse (survivor benefit)
- Death Benefit
  - If you die, minimum guaranteed amount payable on death

Disadvantages of Variable Annuities

- Ordinary income
- Gains are ordinary income vs. capital gains
- No step up in value at death-
- Income in respect of decedent, similar to IRA's or Retirement Plans
- Penalties for early withdrawal
- Taxable portion of withdrawals prior to age 59 ½ subject to 10% excise tax

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Disadvantages of Variable Annuities

- 10% early withdrawal penalty

  Pre-age 59 ½ draws result in a penalty tax of 10% only on the taxable portion of the withdrawal

- 10% penalty **does not** apply:

  1. On death or disability of policyholder
  2. Part of substantially equal periodic payments
  3. Under an immediate annuity contract

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Disadvantages of Variable Annuities

- High fees
- Mortality & expense risk, or M&E fees average 1.41% +
  Underlying mutual fund fees and maintenance fees average 1.52% +
  Total annual fees often exceed 3%
- Surrender charges
- 7% to 10% surrender charges during the first 3 to 10 years are common

Disadvantages of Variable Annuities

- Warning from the Securities & Exchange Commission

  "Approach variable annuities with caution"

  - The SEC issued another cautionary investment brochure regarding the high costs of buying variable annuity.
  - A similar warning came form NASD declaring that variable annuities are unsuitable investments for tax deferred retirement plans such as 401k's or IRA's
  - The brochure highlights the myriad layers of costs….outweigh the benefits!

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Warning from the Securities & Exchange Commission continued

- Bonus credits- “insurance companies will add a credit often from 1% to 5% to entice investors to buy…what investors don’t realize is that this bonus can come along with higher fees and stiffer surrender charges.
- There have been a number of lawsuits filed against insurance companies and sales reps over variable annuity expenses.

Warning from the Securities & Exchange Commission continued

- The brochure points out, “ even though financial professionals are duty-bound to tell their clients if a variable annuity isn’t the best investment choice available, investors still need to ask their advisors hard questions about the costs of owning annuities.”

Disadvantages of Variable Annuities

Limitation of investment options

Investments are limited to the offerings of the insurance or investment company. Often the choices are not the lowest cost option nor do they include the entire universe of mutual funds.

Disadvantages of Variable Annuities

- If you change your mind during the surrender period-you could suffer huge losses
- Less flexibility with your assets
- Lenders won't give you full credit as an asset for credit purposes

Tax Implications-Summary

- Ordinary income vs. capital gains
- Income in respect of a decedent
- Losses on variable annuities are deductible

- All gains are ordinary
- No step up in basis on death of annuitant
- Ordinary loss deduction, Line 14, Form 1040, Rev.Rul. 61-201, 1961-2 C.B. 46.

Tax Implications-Summary

- Losses on variable annuities-*conservative approach.* (Source: BNA 3/03; Michael Benton and Robert S. Keebler)
  - Itemized miscellaneous deduction subject to 2% rule rather than ordinary loss deduction
  - AMT limitation-if you are subject to AMT you lose the ability to deduct ANY miscellaneous itemized deductions

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Who Buys Annuities?

Annuities are sold not bought!!!

People who are misinformed or who have not done their homework!!!

People who have been burned by other types of investments and are promised safety

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When are annuities appropriate?

- Never for a tax deferred account…..
- For individuals only after fully funding retirement accounts; pension, profit sharing, 401k, IRA’s etc.
- For doctors or high risk professionals seeking creditor protection
- For investors seeking guaranteed income for life unavailable elsewhere, e.g. a special needs trust for a child
- Protect assets from a spendthrift
- Medicaid planning-single premium immediate

Who do the informed buy annuities from?

Very low expense ratios, no load mutual ....and index funds and......

No sales commission or surrender charges!

Low Cost producers:	M&E
• Vanguard Investments	.30%
• Fidelity Investments	.25%
• TIAA-CREF	.37%

M&E=insurance expense. Industry average is 1.41%

Source: Morningstar (VARD)

Case Study # 1

- Jacqueline A. xxxxxx
- d/o/b 7/14//38
- IRA
- Date of annuity purchase: 6/09/01
- Investment $150,145
- Type: Variable Equity Indexed Annuity (EIA)
- Return: Maximum return 10% stocks, 11% bonds
- Surrender charges: 17.5%, declining over 16 years

Case Study # 1 continued
2 years after purchase

9/12/03	Annuity Value	Alternative Value
Value	$ 164, 576	$ 163,956
Cash surrender Value	$ 138, 244	$ 163,956
Surrender charge	16%	N/A

Assumptions: Both invested equally in S&P500 and Government Bond Index

Alternative value assumes 9.3% loss in S&P500 and 27.7% gain in Government Bond Index (source: MSN and Yahoo) period 6/9/01 to 9/12/03

Case Study # 1 continued
4 years after purchase

9/12/05	Annuity Value	Alternative Value
Value	$ 186,125	$ 188,037
Cash surrender Value	$ 158,206	$ 188,037
Surrender charge	15%	N/A

Assumptions: Both invested equally in S&P500 and Fixed Income. Annuity fixed portion invested at 3% and Alternative Value in Gov't Bond Index.

Alternative value assumes 14% and 11% gains in S&P500 and 0% and 2% loss in Government Bond Index (source: MSN and Yahoo) periods 9/12/03 to 9/12/05

Case Study # 2

- Donald xxxxxx;
- d/o/b 7/14//38; d/o/d 1/10/03
- IRA inherited by wife, Doris
- Date of annuity purchase: 10/09/02
- Investment $ 61,198
- Type: Fixed Annuity
- Return: 7.5% return year 1; 4% return year 2
- Surrender charges: 10%, declining over 9 years

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Case Study # 2 continued

- Donald owned a whole life Metropolitan Life insurance policy
- Date of purchase: 1965
- Total premiums($1,250 x 20yrs) $25,000
- Cash surrender value: $61,198
- Death benefit (face): $75,000

Donald cashed in life insurance policy on 10/09/02

Donald died on 01/10/03

Case Study # 2 continued

What are the losses to Doris?

1. Income tax on gain $36,198 x 25% = $ 9,050
2. Death benefit difference $75,000-$61,198 = $ 13,802
3. Surrender charges $61,942-$56,031= $ 5,911
4. What else? Can you roll the proceeds of a life insurance policy to an IRA? Penalties……………..

Case Study # 3

- Variable Equity Indexed Annuity (EIA)
- Owner: Profit Sharing Trust
- Insured: Key man
- Initial premium: $35,507

  Split evenly between S&P500 and Fixed

Initial Cap Rate: 7% stocks, 3% fixed

Minimum Cap Rate: 5% stocks, 3%

Surrender charges:15%, declining over 15 years

Case Study # 3 continued

- Problems and Questions
  - If the stock market earns 10%, and the annuity earns 5% after first year….the difference is a 5% expense ratio! WOW!
  - 15% surrender charges….what happens when a participant terminates employment?
  - If the annuitant dies, are the net proceeds allocated only to his or her account or to the whole plan?

The Bottom Line

EIA-Equity Index Annuity producers earned an average of 7.81% of premiums paid in 2003

Source: Annuity Selling Guide, 9/04.

A Final Note

Investment News Magazine

4/25/04: State securities regulators become aggressive in regulating variable annuity sales.

6/14/04: NASD and SEC issue report warning that variable products are inappropriate because of high fees.

10/24/05: American Council of Life Insurers considers suing NASD over the variable annuity suitability rule.

References

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- IRS: www.irs.gov
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