Variable Annuities

The term “annuity” derives from a Latin term meaning “annual” and generally refers to any circumstance where principal and interest are liquidated through a series of regular payments made over a period of time. A “deferred” annuity is an annuity in which both the income, and any taxes due on growth inside the contract, are pushed into the future, until they are actually received by the owner.[1]

A “commercial”,[2] tax-deferred annuity is a contract between an insurance company and a contract owner. In a typical situation, the contract owner contributes funds to the annuity. The money put into the contract is then allowed to grow for a period of time. At a future date, the contract may be annuitized and the accumulated funds paid out, generally through periodic payments made over either a specified period of time, or the life of an individual or the joint lives of a couple.

A variable annuity is a type of annuity in which the contract owner directs the overall investment strategy for the funds placed in the contract.

Fixed vs. Variable Annuities

Two primary annuity types are fixed and variable annuities. Although these annuities share many features in common, the key differences between them arise from the means used to grow the funds contributed by the contract owner.

- **Fixed annuities:** Fixed annuities are characterized by a minimum interest rate guaranteed by the issuing insurance company. Typically, a minimum annuity benefit is also guaranteed. The funds contributed to the contract by the annuity owner are placed in the insurance company’s general account, and the investment risk involved rests entirely on the insurance company. With a fixed annuity, the focus is on safety of principal and stable investment returns.

[1] Under federal law, the deferral of income tax on growth inside the contract is available only to natural persons; the tax-deferral is generally not permitted if the annuity owner is a non-natural person such as a trust or corporation.

[2] In comparison, a "private" annuity is an agreement between individuals, typically exchanging a valuable asset (such as a business) for a lifetime income. The party promising to pay the annuity is someone who is *not* in the business of issuing annuities.

- **Variable annuities:** In contrast, a variable annuity contract generally has no guarantees as to investment return or annuity benefits[1]. The funds contributed by the contract owner are placed in special, variable annuity subaccounts. Within these subaccounts, the annuity owner may choose to invest the funds in a wide variety of investment options. Annuity benefits depend upon the investment results achieved, and the investment risk rests entirely on the contract owner. With a variable annuity, the goal is to provide benefits that keep pace with inflation.

How a Variable Annuity Works

There are two distinct phases involved in the typical deferred variable annuity:

- **Accumulation:** During the accumulation phase, the contract owner contributes funds to the contract through either a single lump sum, or a series of payments. Each payment is used to purchase accumulation units in the investment subaccounts selected by the contract owner.[2] The cost of each accumulation unit is based on the market value of the investments underlying the subaccount, and the number of units outstanding.

  The number of accumulation units can vary, up or down, through additional contributions to the contract, or because of withdrawals from the contract. Any increase, or decrease, in the market price of the underlying investments is always reflected in the value of each accumulation unit. Expenses are deducted daily and are reflected in the value of each underlying unit.

- **Annuitization:** When a contract owner decides to annuitize the contract, the accumulation units are exchanged for annuity units. The number of annuity units received will depend on the price per unit, and certain insurance company assumptions regarding income, mortality and expenses. Once determined, the number of annuity units remains constant. The amount of periodic income payable is determined by multiplying the current value of each annuity unit, by the number of units. As the value of each annuity unit increases or decreases, so does the periodic income.

[1] Unless the contract owner selects the “Fixed Account” option.

[2] Some variable annuity contracts will deduct a portion of each payment for charges and expenses, with the remainder used to purchase accumulation units.

Common Investment Options

Depending on the insurance company and the contract, a wide variety of investment options are often available to the buyer of a variable annuity:

- **Stock:** The subaccount options which may be available can include aggressive growth, focusing on high risk/high return stocks; global and international stock, with equity investments from around the world; and specialty, emphasizing a particular industry or segment of the economy.
- **Bonds:** May include subaccounts focusing on corporate bonds; government bonds; and global or international bonds from around the world.
- **Balanced:** Includes a blend of stocks and bonds.
- **Precious metals:** Some variable contracts will offer subaccount options involving precious metals, such as gold or silver, investing either directly in the metals themselves, or through equity or debt investments in mining companies.
- **Money market:** Includes extremely high-quality short-term debt investments with an average maturity ranging from 30 – 120 days.
- **Fixed account:** In this option, the insurer guarantees a specific rate of return, for a particular period of time. Within a variable annuity contract, this is the only investment option where the investment risk rests on the insurer and not the contract owner.

Optional "Living" Benefit Riders to Variable Annuity Contracts

Many deferred variable annuity contracts offer, for an additional charge, optional "riders" to the contract which, in effect, transfer some of the market risk inherent in a variable annuity back to the issuing insurance company. These optional riders are in effect only during the accumulation phase of a deferred annuity. Once a contract has been annuitized, and regular, periodic payments have begun, the riders expire.

The specifics of how a particular rider work will vary from company to company. In general, however, they function as described below:

- **Guaranteed Minimum Income Benefit (GMIB):** Since the investment results from a variable annuity may be less than expected, the GMIB rider guarantees a minimum income to the annuitant. In order to trigger this benefit, a GMIB rider will typically require that the owner annuitize the contract.
- **Guaranteed Minimum Accumulation Benefit (GMAB):** Rather than guaranteeing a future level of income, as with the GMIB, the GMAB guarantees that the annuity's account value will be a certain dollar amount. With this rider, if the annuity's account value at the end of the guarantee period (generally seven to 10 years), is less than the guaranteed amount, the account value will be "stepped-up" to the GMAB guaranteed amount. This benefit generally does not require that the contract be annuitized.
- **Guaranteed Minimum Withdrawal Benefit (GMWB):**The GMWB rider provides that an annuity owner will be able to withdraw (without annuitizing the contract), on an annual basis, up to a specified percentage of a guaranteed or "protected" dollar amount. The annual withdrawal percentage limit typically ranges from five to seven percent of the remaining protected balance. In effect, the GMWB rider guarantees that an owner will receive back, over a period of years, the entire protected amount, even if the accumulated cash value in the annuity falls to zero. Once the entire protected amount has been withdrawn from the annuity, the contract ends, even if the owner is still alive.
- **Guaranteed Lifetime Withdrawal Benefit (GLWB):** The GLWB is similar to the GMWB in that an annuity owner is allowed to withdraw (not annuitize), on an annual basis, up to a specified percentage of a guaranteed or "protected" dollar amount. The key difference is that withdrawals under the GLWB rider continue for the owner's entire lifetime, even if total cumulative withdrawals exceed the protected dollar amount or the accumulated cash value in the annuity falls to zero.

Other Variable Annuity Contract Provisions

There are a number of key contract provisions that a buyer of a variable annuity contract should be aware of. Among these are:

- **How the contract is driven:** Some contracts are owner-driven while others are annuitant-driven. The word "driven" refers to what happens when a specific party dies or becomes disabled. With an owner-driven contract, the death of the annuitant will not terminate the contract. With an annuitant-driven contract, the death or disability of the contract owner will not result in death benefit payment, but IRC Sec. 72(s) requires payment within five years of death, unless the beneficiary is the spouse.

- **Guaranteed death benefit:** If an annuitant dies before annuity payments begin, the contract will pay the named beneficiary the greater of the investment in the contract (less any withdrawals) or the contract value on the date of death.

- **Enhanced death benefit:** Some variable annuities offer an enhanced death benefit option. This feature provides that upon the death of the annuitant, the beneficiary will receive the greater of the account's value on the date of death, or the original principal (plus any additions) compounded at a specified rate of return, for example, 5% per year. The ultimate death benefit is subject to the claims paying ability of the insurer.

- **Exchange privilege:** Allows the contract owner to periodically change the allocation of funds among the subaccounts. Such exchanges are usually allowed, often without a charge, several times a year.

- **Prospectus:** Variable annuities are considered by the Securities and Exchange Commission (SEC) to be a security. The SEC requires that the purchaser of a variable annuity be given a prospectus, which provides detailed information on how the annuity contract works, the subaccounts available, the risks, and all expenses or charges involved. The SEC also requires individuals selling variable annuities to be licensed to sell securities.

- **Contract fees and charges:** Although there is typically no commission paid when a variable annuity is purchased, variable contracts are subject to a number of fees and charges. A contract may include charges for investment management, paid to the manager of the investment subaccounts; administrative and mortality risk charges to cover the insurer's basic expenses, as well as the cost of the guaranteed death benefit provision; and surrender charges, fees imposed if withdrawals in excess of a certain amount are made, or if the contract is surrendered completely. Surrender charges can range from 0 to 10%, and typically decline over time.

Taxation of Annuity Payments

The tax treatment of payments made from an annuity will vary, depending on where in the life cycle of the annuity the payments are made. In general, the following rules apply:[1]

- **Before annuitization:** Funds withdrawn from an annuity contract prior to annuitization are considered to be made first from interest or other growth.[2] These earnings are taxable as ordinary income. If the annuity owner is under age 59½ at the time a withdrawal is made, the earnings are also generally subject to a 10% IRS penalty.[3] If earnings are completely withdrawn, and payments are then made from the owner's initial investment, the withdrawal is treated as a tax-free recovery of capital.

- **After annuitization:** Regular annuity payments are treated as being composed of part earnings, and part return of capital. The earnings portion is taxable as ordinary income. Once the owner has completely recovered his or her investment in the contract, all remaining payments are fully taxable as ordinary income.

- **Estate taxes:** Any amount payable to a beneficiary under an annuity contract by reason of an owner's death is includable in the owner's gross estate. If an annuitant/owner receiving payments under a Life Only annuity contract dies, no further payments are due, and nothing is includable in his or her estate.

[1] This information is based on federal law. State law may vary.

[2] For annuity contracts entered into prior to August 14, 1982, withdrawals are treated as first coming from principal.

[3] Two exceptions to the 10% penalty involve the death or disability of the contract owner or annuitant, depending on the wording of the contract.

Seek Professional Guidance

Tax-deferred annuities are primarily intended to be long-term investments. Because of this, and because of the complexity of many annuity contracts, an individual considering the purchase of a tax-deferred annuity should carefully consider all aspects before entering into the contract. The advice and counsel of appropriate tax, legal, and other advisors is highly recommended.

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