Indexed 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 tax-deferred annuity is an annuity in which taxation of interest or other growth is deferred until it is actually paid.[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," when the accumulated funds are 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.

An indexed annuity is a type of annuity that grows at the greater of an annual, guaranteed minimum rate or the return based on a formula related to a specific market index. Annuity contract guarantees are based on the claims-paying ability of the issuing insurance company.

Fixed vs. Indexed Annuities

Two primary annuity types are the fixed and variable annuities. (An indexed annuity is a type of fixed-rated annuity.) Although these annuities share many features in common, the primary difference between them is in the mechanism used to credit earnings to the annuity:

- **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. With a fixed annuity, the focus is on safety of principal and a predictable rate of return.

[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, unless the owner is an agent for a natural person.

[2] In comparison, a private annuity is an agreement between individuals, usually 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.

- **Indexed annuities:** In contrast, indexed annuities (IA) are characterized by a contract return that is the greater of an annual minimum rate (typically 3%) or the return based on a formula related to a specific market index, such as the Standard & Poor's 500 index, reduced by certain expenses. If the chosen index rises sufficiently during a specific period, a greater return is credited to the contract owner's account for that period. If the market index does not rise sufficiently, or even declines, the lower minimum rate is credited. An owner is guaranteed to receive back at least all principal, if an IA contract is held for a minimum period of time, known as the penalty period. The penalty period for some indexed annuity contracts can be quite lengthy.

Understanding Indexed Annuities

Although all indexed annuities share the same objective, contracts can vary greatly. The specific structure of a contract will affect the amount and timing of growth in the contract, as well as its liquidity. Below are definitions of some common IA terminology:

- **Term:** This is the length of time the penalty period lasts and/or the time when the investor has the option to renew. The period is commonly three to seven years.
- **Participation rate:** Also known as the "index rate," the "participation rate" is the percentage increase in the index by which a contract will grow. For example, "75% of the S&P's increase for the calendar year" means that if the S&P 500 index increases 10% for the year, the contract would be credited with 7.5%. This rate is usually less than 100%. The participation rate is subject to change by the insurance company.
- **Administrative fee:** This is also known as an annual fee, spread yield, or expense load. It is a fixed charge subtracted annually by the insurer. This fee ranges from 1.0% to 2.25%.
- **Cap rate:** This is the annual maximum percentage increase allowed. For example, if the chosen market index increases 35%, a contract with a 9.0% cap rate will limit the client's increase to 9.0%. The cap rate is subject to change by the insurance company. Some contracts do not have a cap rate.
- **Floor:** This is the minimum guaranteed amount credited to the contract, typically in the three to four percent range. The investor will receive this minimum amount only if the IA is held for a specified, minimum period of time.

- **Reference (contract) value:** This is the amount the investor is entitled to, i.e., the greater of the current account value less any remaining surrender charges.
- **Anniversary date:** This is the beginning of the term used to measure the growth in a contract.
- **Index credit period:** Amounts are credited to a contract at specific points in time. The three most common period methodologies used to determine the credited amount are as follows.
  - **Annual reset:** This measures the change in the market index over a one-year period.
  - **Point-to-point:** While similar to annual reset, the period used is usually five years.
  - **Annual high watermark with look back:** While similar to point-to point, the highest annual anniversary value[1] is used to determine the gain instead, i.e., the largest number at the end of any of the five years.
- **Averaging:** Some indexed annuities will determine any increased contract value based on an average of the monthly changes in the market index, measured over a specified period.

Other Issues

Other issues to keep in mind include the following:

- **Guaranteed death benefit:** Some contracts offer, as an optional feature, a 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.
- **Contract fees and charges:** Although there is typically no commission charged when an indexed annuity is purchased, these contracts are subject to a number of fees and charges. These include administrative and mortality risk charges to cover the insurer's basic expenses as well as the cost of any guaranteed death benefit provisions. Surrender charges may also be imposed if withdrawals in excess of a certain amount are made or if the contract is surrendered. Surrender charges can range from 0 to 15% and typically decline over time. Payment of a surrender charge may result in a redemption less than the principal amount invested.

[1] For example, the credited amount might be the largest number at the end of any of the five years.

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 (i.e., the beginning of regular payments) 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% federal tax 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.

Changes to the annuity contract, including loans, collateral assignments, and ownership changes may also result in income tax consequences.

- **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. Income amounts paid before the owner attains the age 59½ are generally subject to a 10% federal tax penalty, unless the annuitization is made for the owner's life or life expectancy.

- **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.

- **Income in respect of a decedent:** Payments are still subject to income tax when received by the beneficiary. However, the beneficiary may also be eligible for a federal income tax deduction for a portion of the estate tax paid.

[1] The discussion here concerns federal income tax law. State or local law may vary.

[2] Withdrawals from annuity contracts entered into before August 14, 1982 were treated as first coming from principal, to the extent of premiums contributed before August 14, 1982.

[3] Two exceptions to the 10% penalty involve the death or disability of the contract owner.

Seek Professional Guidance

Tax-deferred annuities are intended to be long-term retirement solutions. Because of this and 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 guidance of appropriate tax, legal, and other financial professionals is highly recommended.

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