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ANNUITY PLANS

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INFORMATION LINE 1-800-894-2495
WWW.AHICE.COM
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1

THE CONCEPT OF ANNUITY

OVERVIEW OF ANNUITIES

An annuity unlike a savings or investment account is designed to last for the life of the individual

Unlike savings account where funds can be withdrawn at will, an annuity account is designed to convert a specific sum of money in a series of periodic payments that is guaranteed for the life time or longer of the individual.

In the event an individual cannot start out with a large sum of money to draw from, annuity programs can be structured to accumulate a specified amount of money before periodic disbursements begin.

RISK FACTORS OF AN ANNUITY

For an individual an annuity transfers some of the risk of outliving one's funds to an insurance company, who in turn for the premium, guarantees a specified payback over an agreed period of time for the life or longer of the individual.

As modern medicine expands the life expectancy of individuals, insurance companies can only estimate what this technology will do in extending the average life expectancy, and thus, only estimate the risk of pay out in any specific annuity contract.

THE STRUCTURE OF AN ANNUITY

Like any other insurance contract, an annuity has an owner and a beneficiary, which can be either a different or the same individual.

The common feature of all annuities is a lifetime income and an accumulation period. The accumulation period begins with the deposit of a premium either by lump sum deposit or monthly installments and such deposits earn interest and are compounded within the annuity.

The interest is not taxed as it builds within the annuity thus compounding the additional retained interest. It is because of this additional benefit that annuities make good sense over a savings account where the interest is taxed as it is earned.

During the pay out period the funds received by the individual are a combination or a "blend" of the deposits and interest, which then creates a tax advantage.

Mortality statistic tables help determine the pay out for individuals depending on their age and sex at the time of the contract. Annuities in essence create a pool of individuals from which some individuals will die early, thus creating "uncollected benefits", and some will outlive the "average", and thus require "extra benefits."

The insurance company is the vehicle that organizes the annuity pool.

Life annuities programs are based on mortality factors and pay an individual for life, even beyond his/her life expectancy.

Fixed-period annuities expire at the end of a designated period, regardless of the life or death of the individual and terminate when all the principal and interest are used up.

In the last twenty years annuities have gained such popularity that they have increased in usage by fourteen folds.

The frequency of premiums varies and there are several options depending on the need and goals of the individual.

Level premiums, which were once very popular, have fallen to the wayside in favor of single premiums, periodic premiums, and flexible premium arrangements.

Although level premiums offered the security of what might be compared to a forced savings account, other options offered today often time are more responsive to a variety of individuals needs.

Annuities can be set up as single life coverage, joint and survivor life coverage, or joint life coverage. Once again today's annuities are geared to meet the growing needs of varying households.

PAYOUT FEATURES

The Payout of annuities can be structured as immediate or as deferred.

Immediate payouts usually begin after a lump sum premium has been made and are the result of an individual coming into a lump sum of money wishing to receive disbursement over an extended period of time to insure life time income.

Deferred payouts are usually established by individuals who wish to accumulate additional principal and interest in their annuity and receive its compensation at a later date when there is more financial need.

ACCUMULATING CASH VALUES

There are several ways to accumulate cash values in an annuity plan. There is the fixed and variable method of accumulation.

In the fixed method the insurance company invests the premium in a general investment account and returns to the annuitant a minimum or a pre-designated interest on the return of the investment as agreed in the contract. Fixed guaranteed return annuities yield a lower return due to the fact that the investments are usually made in less speculative vehicles such as bonds and mortgages.

Variable method of cash accumulation offers a more speculative way of acquiring a return. There is no guaranteed return and the insurance company invests funds in a vehicle such as the stock market where the return could be very high, but on the other hand also very low depending on market conditions.

PAYOUT METHODS

Payout methods come in the form of Life Annuities and Temporary Annuities

Life annuities are sub categorized into Straight Life contracts, Guaranteed Minimum contracts, Life with Period Certain contract, Refund contract, Cash contract, and installment contract.

- Temporary Annuities come in Designated Period contract and Designated Amount contract.
- A Straight Life contract pays a benefit as long as the annuitant lives, and then ends.

- Guaranteed Life minimum payout contracts come in two forms-Life Annuity with period certain, and Refund Annuity with cash or installment refund.

- Life Annuity with period certain guarantees that in the event the annuitant dies prior to a specified period, the payments will continue until the specified period is met. Common time frames are five, ten, fifteen and twenty year periods.

- Cash Refund Annuities guarantee that the beneficiary of the annuitant will receive payment in one lump sum for all or any agreed upon portion of the premium paid in the event of the premature death of the annuitant.

- Installment Refund Annuities on the other hand pay to the beneficiary, in installments, all monies owed the annuitant up to the entire premium paid by the annuitant.

- Temporary Annuities do not guarantee lifetime income but on the contrary provide income only for specified periods.

- Temporary Annuities payout either in the format fixed period or fixed amount.

- Fixed Period payments are made for a specified period of time and if the annuitant dies the payments continue to the beneficiary.

- Fixed Amount payments are periodic payments of specified amounts to the annuitant or the beneficiary until the funds are depleted.

SALES AND ADMINISTRATIVE CHARGES

The premiums paid into annuity policies are not all applied to principal but portions are applied to administrative costs and taxes.

Some of these costs include a level sales charge, an investment management group fee, a record maintenance, accounting, or reporting fee.

Some annuities have withdrawal or surrender fees or market value adjustment fees.

Taxes also play a part in fees and costs and in some States a 'State Premium" tax is charged on annuities. Annuities used to fund IRA's, 401k plans and Section 403b and SECTION 457 Plans may be subject to a multitude of taxes.

Most annuities have some form of withdrawal or surrender charge. In some states, the withdrawal or surrender charges are, regulated by state law. In the case of variable annuities, these fees are regulated by the Securities and Exchange Commission.

Some annuities carry a withdrawal or surrender fee for a specified period of time, usually five years, after which the annuitant can move the contract to a different company where perhaps the payback is more to the annuitant's benefit.

Market Value Adjusted annuities often times carry special charges under certain circumstances.

VARIABLE ANNUITIES AND THE LAW

The first variable unity was first issued in the United States in 1952. Because variable annuities pass the investment risk on to the contract owner both the Securities and Exchange Commission and some States consider variable annuities to be securities rather than life insurance products.

Variable Annuities and those individuals who sell them are subject to federal securities regulations as well as state insurance regulations.

Variable contracts must be registered with the Securities and Exchange Commission under the Securities and Exchange act of 1933.

Under this law a prospectus must be filed with the Security and Exchange Commission and this prospectus must be presented to the consumer in connection with any sales effort.

The company selling the variable contract must be registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Brokers/Dealers selling variable annuities must be members of NASD in order to conduct business.

NASD is a self-regulatory organization and brokers/dealers must comply with very strict NASD regulations regarding sales practices.

Individuals selling variable annuities must be licensed both by their state and must be NASD Registered. In some States in addition to a life license individuals must also have a license for variable products.

Net premium payments from variable contracts cannot be deposited in the insurance companies general asset account, but must be deposited in a separate account.

The gains and losses passed through to variable contract owners must represent only the investment experience of the separate account and not any part of the companies assets.

In conclusion this chapter has attempted to bring you an overview of annuity concepts and principals and the rules and regulations that guide them.

FOCUS POINTS

1. An Annuity unlike a savings account is designed to last the life of the individual.
2. An Annuity is designed to convert a specific sum of money in a series of periodic payments.
3. Annuities guarantee a contract holder payments for life or longer.
4. Annuity programs can be structured to start out with one lump sum of money.
5. Annuity programs can be structured to accumulate a specified amount before disbursement begin.
6. An annuity transfers some of the risk of outliving one's funds to an insurance company.
7. In turn for the premium, an insurance company guarantees a specified payback.
8. An Annuity is an insurance contract that has an owner and a beneficiary.
9. An owner and beneficiary can be one and the same person or different individuals.
10. The common feature of all annuities is a lifetime income or an accumulation period.
11. The accumulation period begins with the deposit of a premium.
12. The difference between a savings account and an annuity is that the interest on the annuity is not taxed until disbursement.
13. Annuities create a pool of individuals some with "uncollected benefits" and some requiring "extra benefits."
14. Life annuity programs are based on a mortality factor.
15. Fixed period annuities terminate when all the principal and interest are used up.
16. Annuities can be set up as single life, joint and survivor, or joint live coverage.
17. The payout of annuities can be structured as immediate or as deferred.
18. Immediate payouts usually begin after a lump sum premium has been made.
19. Deferred payouts begin at a later date after additional principal is accumulated.
20. Cash values in an annuity are accumulated either in a fixed or variable method.
21. In the fixed method the insurance company returns the annuitant a minimum or pre-designated interest of the investment.

22. In the variable method there is no minimum guarantee of return to the annuitant.

23. Payout methods come in the form of Life or Temporary annuities.

24. Temporary annuities come in the form designated period contracts or designated amount contracts.

25. Straight life contracts pay a benefit for the life of the annuitant.

26. Guaranteed life contracts come in two forms-Life with period certain and Refund Annuity with cash or installment refund.

27. Life Annuity with period certain program pays for a period of time even if the annuitant dies prior to the agreed time.

28. Cash Refund Annuities guarantee the beneficiary one lump sum payment if the annuitant dies prior to using up the paid up premium.

29. Installment Refund Annuities pay the beneficiary installment payments until all of the premium collected is paid out.

30. Temporary Annuities provide income for a specified time period.

31. Temporary Annuities payout in either fixed period or fixed amount.

32. Some of the premiums paid into annuity policies are applied to sales and administrative charges.

33. Some annuities have withdrawal or surrender fees or market value adjustment fees.

34. Some annuities are subject to a "State Premium Tax"

35. Most annuities have some form of withdrawal or surrender charges.

36. In the case of variable annuities withdrawal or surrender fees are regulated by the Securities Exchange Commission.
37. Some annuities carry a withdrawal or surrender fee for a specified period of time.

38. Variable annuities pass the contract risk to the contract owner.

39. Variable Annuities are subject to state regulations and federal securities regulations.

40. Variable contracts must be registered with the Security Exchange Commission.

41. Variable contract offerings must be presented to a consumer together with a prospectus.

42. Companies selling variable contracts must be registered with the Securities Exchange Commission.

43. Broker/Dealers selling variable contracts must be members of NASD.

44. Individuals selling variable contracts must be licensed with their state and must be NASD registered.

45. Net premium payments from variable contracts must be deposited in a separate account by the insurance company.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- Outline the differences between an annuity and a savings account
- Outline the structure of an annuity.
- What is the main tax benefit regarding an annuity over a savings account
- How does the mortality factor effect an annuity
- Outline the various forms of premium options and their effect on the annuity.
- What are the different payout features of an annuity
- Outline the various methods of accumulating cash values in an annuity.
- Outline how sales and administrative charges effect an annuity.
- Outline how state and federal regulations effect variable annuities versus fixed annuities.

2

ANNUITIES

WHAT IS AN ANNUITY?

An annuity is an investment that is made through an insurance company. It is a contractual relationship between the contract owner (person covered by the annuity) and the particular insurance company.

Annuities can be sold through insurance agencies, banks, savings and loans institutions, brokerage firms, investment advisors, and financial planners. Although annuities are sold only by the insurance industry, they do not have anything to do with life insurance or insurance coverage.

When an annuity is purchased the insurance company makes certain assurances. Guarantees vary according to the type of annuity.

There are two types of annuities:

1. Fixed (this provides a set rate of return), and
2. Variable (the contract owner chooses where the money goes. Investment options range from conservative to aggressive).

WHO PARTICIPATES IN THE ANNUITY?

There are four parties to each annuity:

- The Insurer;

- Contract Owner;
- Annuitant; and
- Beneficiary.

The Insurer

There are more than 2,000 insurance companies doing business in the United States and the vast majority deal in annuities.

Regardless of the source providing the annuity for sale—banker, financial planner, brokerage firm or any individual or business licensed to sell annuities—the annuity agreement is always between the contract owner and the insurance company.

The insurance company or the insurer invests annuity money. The insurer also makes certain guarantees to the contract owner, and these guarantees are outlined in the annuity contract. The contract is the instrument the insurer uses to define the terms and conditions governing the use of the annuity and the annuity funds.

The annuity contract outlines rules governing:

- Additional Investing
- Withdrawals
- Cancellations
- Penalties
- Guarantees

Agreements and Applications

An investor purchasing a certificate of deposit (CD) from a bank signs an *agreement*. For the purchase of a mutual fund, the investor fills out an *application*. In each case the relationships are between the investor and the financial institution. Investment in an annuity is structured the same way.

Contract Owner

An individual investing in an annuity is known as the *contract owner.* The contract owner chooses investment options. The contract owner has the right and ability to:

- Add additional funds to the annuity;
- Terminate the annuity;
- Withdraw all or part of the money; and

- Change parties named in the contract.

The contract owner can be any one of the following:

- Couple
- Trust
- Corporation
- Partnership

If the contract owner is an individual, he must be a legal adult. Minors may be contract owners only if the policy lists the minor's custodian. The contract owner controls the investment and can gift or will part or all of the contract to anyone or any entity.

The Annuitant

A *life insurance* policy names the insured party. The life policy continues in force until:

- The owner terminates the contract;
- The owner fails to make premium payments; or
- The insured dies.

With an annuity, the contract remains in force until:

- The contract owner makes a change; or
- The annuitant dies.

An annuitant is like an insured in a life policy. Although the annuitant must sign the annuity contract, the annuitant is subject to following restrictions:

- No control of the contract
- Cannot make withdrawals
- Cannot make deposits
- Cannot change the parties to the contract
- Cannot terminate the contract

The contract owner may name anyone as the annuitant—the contract owner, spouse, parent, child, relative, friend or neighbor. The annuitant must be a ***person*** (not living trust, corporation, partnership etc.) currently living. This is the only qualification in naming an annuitant.
The maximum age allowed for the annuitant depends on the insurance company issuing the annuity contract. As a rule, the annuitant must be under age 75 at date of signing. Some companies set a maximum age of 70 or 80. The contract may still be in force even though the annuitant has reached the maximum age limit.

Most annuities provide that the contract owner may change the annuitant at any time, with the stipulation that the new annuitant was alive when the original contract was executed.

Beneficiary

The beneficiary of an annuity will only benefit or prosper from that annuity upon the death of the annuitant. The named beneficiary(s) can be children of the annuitant, friends, relatives, spouse, neighbors, trusts, a corporation or a partnership.

The annuity application will allow multiple beneficiary designations of varying or similar proportions.

Example: a beneficiary designation may read:

25% to Jane Smith
15% to John Smith
10% to Millie Smith
50% to the Smith Family Trust

Should the contract owner be a solitary individual, the contract owner may name himself contract owner and annuitant, while listing a loved one or entity such as a living trust, charity or corporation, as a beneficiary. This affords the individual complete control over the annuity investment during his lifetime.

The contract owner may change the beneficiary(ies) at any time and consent of said beneficiary(ies) is not necessary.

Multiple Titles

The same person can hold *multiple titles* in the annuity contract. For example, the contract owner may also be the beneficiary. Or, the contract owner could be the owner, annuitant and beneficiary.

If the contract owner designates a living trust or a corporation as the beneficiary, the corporation or trust can only be the contract owner and/or beneficiary—a living *individual* meeting the insurer's age restrictions (couples excluded) must be named as the annuitant. The insurer is always the insurance company.

HOW AN ANNUITY WORKS

Structuring the Annuity

A client's investment options may include:

- Certificates of deposit
- Government bonds
- Mutual funds
- Money market accounts
- Real estate
- Annuities

A client investing in an annuity must complete an application furnishing the following information:

- Name;
- Current address;
- Social Security of the contract owner;
- Name, Social Security number, address, sex and date of birth of the annuitant;
- Investment options;
- Type of money used (For example: Is it a rollover?);
- Signature of the contract owner; and
- Signature of the annuitant.

Following the submission of the application to the insurance company the contract owner receives the contract. The contract contains a cover sheet that summarizes the application, denotes the rate of expected return on the investment(s) and indicates type(s) of investments selected.

The contract owner has the right to gift all or part of the investment to someone else, change the beneficiary, or change the name of the annuitant.

FREQUENTLY ASKED QUESTIONS

Can I Invest Money in Different Ways?

Whether the contract owner opted for a fixed-rate or a variable annuity, both have two stages:

- The accumulation period; and
- The payout period.

The accumulation period goes into effect the moment the investments are selected. During the accumulation phase, the account balance grows, tax-deferred, as either interest is credited by the insurance company (for a fixed annuity), or investment results are credited (for a variable annuity).

The payout period goes into effect the moment benefits (payments from the annuity) are disbursed. The payout phase can provide a guaranteed amount for a guaranteed period of time.

A single-premium deferred annuity is structured so that the investment is made in one payment. The contract owner can make one or more payments of various amounts to a flexible-premium deferred annuity.

Is an Annuity a New Type of Investment?

Annuities have been available in other countries for several hundred years. They have been available in the United States for more than 100 years.

What Risk is involved?

As with any type of investment, caution should be used and investments carefully scrutinized. Annuities can be improperly sold or misused. Some types of annuities are not guaranteed and, although the potential for long-term growth is exceptional, they depend upon the market and the investments chosen to retain their value.

What are the Advantages of an Annuity?

- An annuity is a safe vehicle for investment;
- Annuities offer tax-deferred growth on earnings; and
- Annuities provide resources that last as long as the client needs them.

FOCUS POINTS

1. An Annuity is an investment made through an insurance company.
2. An Annuity is a contractual relationship between an owner {annuitant) and the insurance company.
3. Annuities can be sold through insurance agencies, savings & loans, brokerage firms, investment advisors, and financial planners.
4. In selling an annuity the insurance company makes certain assurances or guarantees that vary with the type of annuity.
5. A Fixed annuity provides a set rate of return.
6. A variable annuity allows the contract owner to choose where the money goes and investment options range from conservative to aggressive.
7. There are four parties to each annuity the insurer, the contract owner, the annuitant and the beneficiary.
8. The annuity agreement is always between the contract owner and the insurance company.
9. The annuity contract outlines rules governing additional investing, withdrawals, cancellations, penalties, and guarantee
10. An individual investing in an annuity is known as the contract owner.
11. The contract owner can be a couple, a trust, a corporation, or a partnership.
12. The contract owner controls the investment and can gift or will part or all of the contract to anyone or any entity.
13. An annuity contract remains in force until the contract owner makes a change or the annuitant dies.
14. An annuitant has no control of the contract, cannot make withdrawals, cannot make deposits, cannot change the parties to the contract and cannot terminate the contract.
15. The contract owner can name anyone as the annuitant who is a living person.
16. As a rule most insurance companies require the annuitant to be under the age of 75.
17. Most annuities provide that the contract owner may change the annuitant at any time.
18. A beneficiary will only benefit upon the death of the annuitant.

19. A contract owner may be an annuitant and beneficiary.

20. In an annuity a client's investment options can include certificates of deposit

21. government bonds, Mutual funds, money market accounts, real estate, and annuities.

22. An annuity contract cover sheet summarizes the application, denotes the rate of expected return, and indicates type or types of investments selected.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- What is an Annuity and who sells them.
- Outline the role of the insurer in an annuity.
- Define the role of the insurer in an annuity program.
- Define the role of the contract owner in an annuity.
- What is an annuitant and to what restrictions is the annuitant bound.
- Outline at what point and in what manner the beneficiary receives a benefit from the annuity.
- Discuss how multiple titles can be held under an annuity contract.
- What elements can be used in structuring an annuity
- Outline the key elements required in an annuity application.
- What are the rights of a contract owner under an annuity policy.

3

ANNUITY BASICS

RENEWAL RATE

The renewal rate is the interest rate credited to an annuity in the years following the initial rate. This renewal rate is seldom identical to the new money rate, and with good reason. The new money rate reflects the investments that the insurance company is buying today. The renewal rate reflects what the insurance company bought when the annuity was initially purchased. Investigate the selected insurance company's renewal rate strategy for any differences to this standard.

Lifetime Guaranteed Rate

The lifetime guaranteed rate is the minimum interest rate that is guaranteed for the life of the annuity. Each state department of insurance has jurisdiction over the many fixed annuities and mandate that annuities provide this lifetime guaranteed interest rate. Since the interest rate is for the life of the annuity, most insurance companies offer rates of three to five percent.

Settlement Options

When a contract owner elects a settlement option, the entire annuity value is applied for guaranteed income.

Settlement options specify the way the contract owner receives funds from the annuity. The contract owner has several options for receipt of guaranteed income. In fact,

guaranteed income can be received on a monthly, quarterly, semi-annual, or annual basis.

Money Back Guarantee

The money back guarantee found in many annuity contracts is considered by some as a major selling feature since there is no market risk for the customer. The insurance company assumes the risk, and the customer receives protection.

If a contract owner is unhappy with his annuity 10, 20, or 30 days (depending on the insurance company) after the annuity is issued, he can get all of his money back. In addition, many annuities contain guarantee of principal language, which states that surrender charges will never dip into principal. In other words, the contract owner cannot get back less than his initial premium.

Surrender Charges

Surrender charges protect the insurance company just as guarantee of principal protects the customer. Surrender penalties with most annuities disappear over a five to ten year period (excluding the ten percent free partial withdrawal). For example, a typical penalty might be seven percent if the annuity is surrendered during year one. Penalties may then decrease one percent each year. Some annuities have surrender charges such as 'the first six month's interest.

Bailout Clause

A bailout clause is an agreement by the insurance company to waive surrender charges under certain conditions. This most common example is an "interest rate" bailout clause (also known as an escape clause). Simply put, the insurance company will waive surrender charges if the interest rate decreases below a certain level. Some annuities have other bailouts. For example, some annuities waive surrender charges if the contract owner is confined to a nursing home, or charges could be waived if a terminal illness is diagnosed.

FOCUS POINTS

1. The renewal rate is the interest rate credited to an annuity in the years following the initial rate.
2. The lifetime guarantee rate is the minimum interest rate that is guaranteed for the life of the annuity.
3. Settlement options specify the way the contract owner receives funds from the annuity.
4. Guaranteed income from an annuity can be received on a monthly, quarterly, semi-annual or annual basis.
5. The money back guarantee provision found in many annuity contracts creates a no market risk scenario for the customer.
6. Surrender charges protect the insurance company for a period of time (usually 5 to 10 years)
7. A bailout clause is an agreement by the insurance company to waive surrender charges under certain conditions

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- Outline the differences between the renewal rate and the lifetime guarantee rate.
- What is a money back guarantee and how does it effect an annuity
- What part do surrender charges play in the annuity contract.
- What is a bailout clause.

4

TYPES OF ANNUITIES

INCOME AND INVESTMENT

Annuities can be divided into two major applications for the client:

- The need for income; and
- Options for investment.

Clients have two choices for income needs, depending on when the need for income occurs: an *immediate annuity*, or a *deferred annuity*.

Investment options include the *fixed-rate annuity* and the *variable annuity*.

Immediate Annuity

An immediate annuity will provide income right away, in some cases just 31 days after purchase of the annuity. Clients that need to receive a specific amount of money each month should investigate the immediate annuity. Money from an immediate annuity may be used as sole source of income or a supplement to other income.

Immediate annuity payments may be made monthly, quarterly or annually. The amount of the check the client receives will not fluctuate from month to month. The actual dollar amount of the checks is in direct relationship to the total annuity investment.

Most clients do not realize that insurance companies can become very competitive for annuity and large investments. Contact several insurance companies for rates and payouts, and ask for specific payout amounts for five, ten, 20 and 30 years on the

intended amount of annuity investment. Use these figures to compare rates and payout amounts with other insurance companies.

Deferred Annuities

A deferred annuity is used for growth, and offers flexibility for growth either over a long or short period of time.

The contract owner can receive a certain dollar amount of income each year and direct that the balance be reinvested. The deferral process affords a great deal of flexibility because, in addition to automatic reinvesting, the contract owner also has the ability to terminate the investment or simply withdraw a portion of the principal.

Fixed-Rate Annuities

A fixed-rate annuity affords the client a guaranteed rate of return. The rate of return received from a fixed-rate annuity depends on the length of time the funds will be invested. The most common maturity periods for annuities are one, three and five years. The insurance company guarantees the rate of return for the contracted period. Typically, the longer the commitment, the higher the guaranteed rate.

With a fixed annuity, the rate is guaranteed rate regardless of:

- Stock market gains or losses;
- Rising or declining interest rates; and
- Insurance company performance (profits or losses).

The fixed-rate annuity assures the investor safety of principal and the exact interest the money will earn. The fixed-rate annuity is especially attractive to conservative investors, or any investor who wants specific projections on his investment.

The fixed-rate annuity is not just for the timid or cautious. These investment vehicles have proven to be an excellent stabilizing force for the moderate or aggressive investor who needs balance in his overall portfolio.

With the fixed-rate annuity the diversified investor, with other investments in real estate, stocks, bonds, gold, or mutual funds, feels safe and secure with this aspect of his overall investment program guaranteed.

Variable Annuities

Not every investor seeks a guaranteed rate of return. Many investors subscribe to the investment adage that the bigger the risk, the bigger the return—the smaller the risk, the smaller the return. Investing in a variable annuity can be compared to investing in a mutual fund.

Mutual funds offer the investor a choice of funds in which to invest. The choice of funds provides the investor with variety but it can also create a burden, forcing decisions for investment in stocks, bonds, and money market instruments. The investor must make smart choices, and combine investment options where necessary, investing in combinations of funds.

The investor has total control of his investment choices with a mutual fund or an variable annuity. The insurance company plays no part in directing the investments of a variable annuity. The insurance company does not share in any profits earned on the annuity, nor will it absorb any losses. If an annuity earns 50 percent in one year, the contract owner keeps the entire amount. Conversely, if an annuity suffers a 60 percent loss in one year, there is no recourse.

WHICH ANNUITY IS BEST?

Billions of dollars are invested every year in both fixed-rate and variable annuities. Determine the type of annuity (fixed or variable) to recommend to a client based on his investment and income goals, and the 'time horizon' in which to achieve these goals.

Time Horizon

Clients willing to wait for investment returns should concentrate on equity instruments, such as stock. Over time, common stock and equities perform better than any other assets. A client with a time horizon of only one or two years should consider a fixed-rate annuity.

An optimistic or *aggressive* investor with a time horizon of less than two years may consider a variable annuity. The average investor should only consider variable annuities for a time horizon of three or more years. Most conservative investors consider stocks too risky.

Goals and Objectives

The common goals of an investor are to retire comfortably, provide children with a college education, and purchase a home or real estate.

Evaluate a client's goals and turn those goals into "dollar objectives." For example, if a client's goal is to retire comfortably, achieving that goal may require an investment that would generate a retirement income of $2,000.00 a month, or $10,000.00 every two weeks, depending on his expected standard of living. A client desiring a $54,000.00 per year income would need at least $600,000 earning nine percent interest a year over 25 years.

FREQUENTLY ASKED QUESTIONS

Can risk be calculated in advance?

No. Advise every client to evaluate carefully investment choices.

Can I hedge an investment in two annuities?

The best solution is to structure a variable annuity by diversifying among several different sub-accounts. Some insurance companies offer a part fixed, part variable annuity that is often referred to as a hybrid annuity.

FOCUS POINTS

1. Annuities provide two options to clients- the need for income and options for investment
2. Clients have two choices for income need- immediate or deferred.
3. Investment options include a fixed annuity and a variable annuity.
4. An immediate annuity begins to provides income as quickly as within 31 days.
5. Immediate annuity payments may be made monthly, quarterly or annually.
6. A deferred annuity offers flexibility for growth over a long or short period of time.
7. A fixed rate annuity affords the client a guaranteed rate of return.
8. The rate of return received from a fixed rate annuity depends on the length of time the funds will be invested.
9. The most common maturity periods are one, three and five years.
10. With a fixed annuity the rate is guaranteed regardless of stock market gain or loss, rising or declining interest rates or insurance company profit or loss.
11. Investing in a variable annuity can be compared to investing in a mutual fund.
12. In a variable annuity, like in a mutual fund the investor has total choice of funds in which to invest.
13. The average investor with a time horizon of three or more years is suited for a variable product.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- What are the two major client applications for annuities
- What are the four different types of annuities and their application and benefit.
- How do the goals and objectives of a client effect their decision on the choice of annuities?

5

ANNUITY INVESTING ADVANTAGES

FEATURES

There is no such thing as the perfect investment, however, an annuity provides more features than any other type of investment available, including:

- Safety
- Reserves
- Financial strength
- Ratings

Safety

By all investment standards the fixed-rate annuity investment is unequaled. In a fixed-rate annuity principal is guaranteed every single day. In addition, the contract owner is permitted to terminate the contract at any time—after a day, month or year.

In addition to the principal guarantee the interest rate also is guaranteed. The interest rate is guaranteed for a specific period of time, depending on the contract. Variable annuities are less safe because the investor decides the type of portfolio to enter into and the dollar amount that is going to be invested.

Reserves

Banks must, by law, set aside a certain amount into reserves for every dollar deposited into the bank. That amount can range from zero cents to ten cents on the dollar. When a fixed-rate annuity is purchased the insurance company must also, by law, set aside reserves.

The insurance company can use the reserves for settling withdrawals and redeeming annuities. Insurance company reserve money *cannot* be used to pay claims, overhead, bad debts or any other non-related annuity items.

The insurance company accumulates the money to put into reserve from other profit centers. As a rule the insurance carriers' annuity business represents the smallest source of its revenue and the money can be obtained from the carrier selling life insurance and other forms of insurance.

Most states now require that the insurance company become part of the legal reserve pool. This pool protects the investor. Should an insurance company go out of business the reserve pool operates in a straightforward manner and the remaining insurance companies must reserve the liabilities and the obligations of the carrier that went out of business.

Financial Strength

There are more than 2,000 life insurance companies in the United States, and they collectively own, manage or control more assets than all the banks in the world combined. Collectively they own, manage or control more assets than all of the oil companies in the world combined. During the Depression the insurance companies, not the federal government, bailed out the banking industry.

Ratings

Annuities have a perfect track record, but consideration should be given to the insurance company providing the annuity. Some companies are safer than others.

The oldest rating company in the county is *A.M. Best*. They rate companies in the following manner:

- A+ superior rating
- A excellent rating
- excellent rating also
- B+ very good
- B good
- B good
- C+ fairly good
- C fair
- fair

Most investors prefer to stick with the A+ or A rated companies for fixed-rate annuities. For variable annuities, the rating of the insurance carrier is of little importance because the earnings are not tied to the solvency of the insurer.

Performance

Fixed-rate annuities offer a specific rate of return for a specified time and the rate is fully guaranteed for this period. The interest rate guaranteed depends on the annuity.

Professional Management

Professional management plays a very important role in the annuity field. The investment team or professional manager that oversees an annuity portfolio is in fact a specialist. These individuals are highly skilled and trained to focus on a certain segment of the marketplace. There are several independent sources that track the performance of fixed-rate and variable annuities. Some of these rating services are:

- Morningstar
- Lipper Analytical Services
- VARDS
- Standard & Poor's

In addition, *The Wall Street Journal* and *Barron's* publish articles from time to time related to annuities and annuity performance.

WITHDRAWAL OPTIONS

All or part of the money invested in a fixed-rate or variable annuity may be withdrawn, however, that withdrawal may be subject to a penalty. As a rule, most insurance companies permit annuity withdrawals of up to ten percent per year without cost, penalty or fees. The 10 percent withdrawal usually is based on a percentage of the principal, not the value of the annuity.

A few insurance companies will permit withdrawals up to 15 percent per year but it is important to note:

1. It is estimated that 75 percent of all people investing in annuities never remove any money; and
2. The restrictions that apply to withdrawals will eventually disappear.

Variable Annuity—Guaranteed Death Benefit

A variable annuity automatically contains a guaranteed death benefit, which provides that upon the death of the annuitant, the beneficiary will receive:

1. The greater of the principal, plus any ongoing additions, or
2. The value of the account on the date of death.

The variable annuity guaranteed death benefit makes it an ideal investment for an older person desiring a high-income stream. The variable annuity guaranteed death benefit is based on the sum of all investments made by the owner, or value on the date of death, whichever is greater.

The guaranteed death benefit will last until:

1. The annuitant terminates the contract,
2. The annuitant annultizes the investment,
3. The annuitant dies, or
4. The annuitant reaches a certain age, usually 75 or 80 years old.

AVOIDANCE OF PROBATE

When an individual dies, the value of the following become part of the decedent's estate:

1. Assets
2. Real Estate
3. Bank Accounts
4. Boats
5. Stocks
6. Vehicles
7. Clothes

Probate fees are based on the gross value of the estate. This fee may be much higher than anticipated since the value of the estate will increase between now and the individual's death, and the lawyer who probates the estate may ask the court for additional fees

The value of an annuity will not be included when the gross estate is valued.
ALL ANNUITIES AVOID PROBATE.

FREQUENTLY ASKED QUESTIONS

How Important are Rates?

Rates are very sensitive. Even a fraction of a percent can be very important in calculating the returns on an annuity. Rate shopping is a critical factor when choosing an annuity. Actually, the insurance company itself is of secondary importance.

How Important is Professional Management?

Investing in an annuity is like hiring a professional manager. By hiring professionals to manage the funds, the investor does not have to worry about the day-to-day fluctuations of stocks and bonds, or wonder if securities being purchased are about to be downgraded.

What Can Tax Deferral Mean to Me?

The investor pays no taxes on the interest earned so long as that interest remains in the contract. Money that normally would be paid to the federal government as tax works for the investor instead.

How Does an Annuity Compare to an Individual Retirement Account (IRA)?

There are some major differences between IRAs and annuities. For example, only those with earned income can open an IRA, but anyone can purchase a fixed-rate or variable annuity.

An IRA limits the amount that can be contributed annually. An annuity has no limits on contribution. IRA contributions can be tax deductible. As a rule there are no deductions allowed for payments into an annuity.
An annuity can provide a guaranteed income for life—with an IRA there is no such guarantee.

FOCUS POINT

1. Annuities provide safety, reserves, financial strength and ratings.

2. A fixed rate annuity provides a guaranteed principle and the ability for the owner to terminate the contract at any time.

3. A fixed rate annuity provides for a guaranteed interest rate for a specified period of time.

4. When a fixed rate annuity is purchased the insurance company must, by law, set aside reserves.

5. Insurance company reserves cannot be used to pay claims, overhead, bad debts or any other non-related annuity items.

6. Most states require that insurance companies become part of a legal reserve pool to protect investors.

7. Collectively insurance companies own, manage, or control more assets than banks.

8. Collectively insurance companies own, manage, or control more assets than all the oil companies of the world.

9. All or part of the money invested in a fixed or variable annuity may be withdrawn.

10. Withdrawals may be subject to penalties.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- Why does a fixed rate annuity provide a "safety" element of investment
- Discuss the term "reserves" as it relates to insurance
- What roles do ratings play in the insurance field
- What are the different rating categories and how is each category defined.
- How do withdrawal options work
- How do annuities effect the probate process.

6

DISADVANTAGES OF ANNUITY INVESTING

PENALTIES AND EXPENSES

There are very few disadvantages with respect to investing in annuities, and most of them will never affect the client. The three major disadvantages are:

1. IRS penalties;
2. Insurance company penalties; and
3. Ongoing expenses of variable annuities.

IRS Penalties

Regardless of the type of annuity purchased, all annuities will be subjected to an IRS penalty of ten percent for withdrawals that are made prior to the annuitant attaining the age of 59½ years.

The ten percent penalty is not invoked if:

1. The annuitant dies;
2. The annuitant becomes disabled;
3. Annuitization (when a portion of the annuity's assets are paid out as income on a regular basis); or
4. The annuitant reaches age 59 ½.

Income Taxes

Money invested in an annuity will grow and compound tax-*deferred* not tax-*free.* Income tax liability can be postponed indefinitely. Taxes can be further deferred if:

1. The surviving spouse remarries; or
2. The surviving spouse is named as the annuitant and their new spouse is a beneficiary.

When both spouses die the beneficiary would be able to postpone taxes for up to an additional five years.

The tax liability will be the value of the annuity at time of death less the amount invested, and then multiplied by the beneficiary's tax bracket percentage. The contract owner is wise to withdraw money from the annuity when in the lowest tax bracket.

Insurance Company Penalties

The proper terminology for an insurance company penalty is *surrender charge*. The surrender charge only applies if a certain amount of money is withdrawn from the contract within a set number of years.

In an annuity up to ten percent per year may be withdrawn without penalty, after the first year. The insurance company surrender charge occurs when amounts are withdrawn in excess of the free withdrawal privilege of ten percent.

Analyze the insurance company's penalty schedule prior to purchasing an annuity. Some companies' penalty periods last ten or more years, and the penalty can be as high as ten percent for the entire ten-year period.

Surrender charges do not apply if:

1. The annuitant dies;
2. The annuitant becomes disabled;
3. Annuitization;
4. Withdrawals are limited to those allowed under the free withdrawal privilege';
5. The penalty period has lapsed; and
6. Systematic withdrawals of ten percent per year are made.

ONGOING EXPENSES OF THE VARIABLE ANNUITY

The ongoing expenses of a variable annuity consist of the mortality and expense fee and annual contract maintenance charges.

Mortality and Expense Fee

All variable annuities have a mortality or expense fee commonly referred to as guaranteed death benefit. This fee is levied against the account balance each year, and represents a source of the insurance company's profit. This fee fund the insurance company's payments of overhead, commissions, set up fees and death benefit claims.

This fee can range from 1.1 percent to 1.5 percent. The most common mortality charge is 1.2 percent. The variable annuity contract specifies that this fee is "frozen" and it can never be increased. The fee is usually described in a prospectus and will not appear on any quarterly or annual statements.

The mortality charge is used pay commissions and overhead costs that the contract owner would normally have to pay in an up-front or continuing sales charge. It provides funds that allow the insurance company to hire the best money managers, and the mortality charge insures the integrity of the guaranteed death benefit.

Annual Account Maintenance Charge

This charge is minor when compared to the mortality fee. The annual contract maintenance charge will range from $25 to $50. This charge will be noted on the fourth quarter statement issued by the insurance company, and will be deducted from the then-current value of the annuity.

This fee can never be increased during the life of the contract.

FREQUENTLY ASKED QUESTIONS

Can I Get to My Money if I Need it?

Generally annuity contracts do provide liquidity features. Withdrawals of fixed dollar amounts may be made without charge dependant on how the annuity has been in force. However, surrender charges may be incurred. When surrendering the contract the surrender benefit generally is equal to the contract value (premiums plus interest) less any surrender charges.

59½ years of age and Older— Lump Sum or Annuitize?

Annuitization only subjects a portion of the amount withdrawn to taxation. Taking a lump sum, however, subjects the entire growth and interest to income taxes.

Are There Taxes or Penalties for Withdrawing the Entire Annuity and Then Putting the Entire Amount Back?

The IRS is not forgiving. Monies cannot flow in and out of annuities without a tax being imposed. However, most insurance companies provide a grace period for withdrawals.

What is the Insurance Company's Charge for Its Services?

While it is true that charges will vary from company to company the most common charge imposed by the insurance company is the surrender charge. The surrender charge comes into play only when withdrawals of all or part of the annuity are made after a certain number of years specified in the contract have passed.

FOCUS POINTS

1. The three major disadvantages of annuities are IRS Penalties, insurance company penalties, and ongoing Expenses of variable annuities.

2. Annuities are subject to a 10% penalty on withdrawals prior to age 591/2.

3. The 10% penalty is not invoked if the annuitant dies, becomes disabled, or annuitization occurs

4. Money invested in an annuity will compound tax deferred not tax free.

5. Taxes can be further deferred if the surviving spouse remarries or if the surviving spouse is named as the annuitant and the new spouse is a beneficiary.

6. When both spouses die the beneficiary may postpone taxes for up to 5 years.

7. The tax liability will be the value of the annuity at the time of death minus the amount invested and then multiplied by the beneficiary's tax bracket.

8. The term for an insurance company penalty is a surrender charge.

9. Surrender charges only apply if a certain amount of money is withdrawn from the contract within a set number of years.

10. Up to 10% per year may be withdrawn without penalty, after the first year.

11. .Surrender charges do not apply if the annuitant dies or becomes disabled, annuitization occurs, or withdrawals are limited to the allowed free withdrawal privilege, period has lapsed, systematic !0% withdrawals are made.

12. Variable annuity expenses consist of an annual contract fee and a mortality and expense fee.

13. Mortality and expenses fees are levied against an account annually by an insurance company

14. To fund the company's payments of overhead, commissions, set up fees and death benefit claims.

15. Mortality fees on a fixed contract range from 1.1 to 1.5%.

16. Mortality fees on variable contracts are usually "frozen".

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- What are the three major disadvantages to annuities?

7

MUTUAL FUNDS VS ANNUITIES

COMMON FEATURES

Mutual funds and annuities share some common features. Each:

1. Is easy in which to invest;
2. Is easy to monitor;
3. Has professional management;
4. Has outstanding track records;
5. Offer investment options;
6. Provide options to increase the investment;
7. Provide options to withdraw funds;
8. Offer Dollar-Cost averaging.

NOTABLE DIFFERENCES

Mutual funds and annuities differ in several areas, including:

1. Commissions;
2. Taxation;
3. Performance;
4. Withdrawal options;
5. Investment choices; and
6. Safety.

Commissions

Mutual fund commissions range from one to 8.5 percent and this commission usually is subtracted from the investment. Fixed and variable annuities do not charge the investor a commission. If additional contributions are made to the initial annuity investment there are no commission charges.

Taxation

Mutual funds are subject to income tax on certain earnings:

1. The dividends or interest generated by the securities;
2. Capital gains realized when stocks or bonds are sold; and
3. Profits received upon the sale of shares or when changes are made within the mutual fund family.

The investor cannot control the amount of dividends or interest generated by the securities, or the capital gains realized when stock or bonds are sold. These returns are decided by the performance of the fund, and income tax will be determined accordingly.

The only income the investor can control is profit received upon the sale of shares or when changes are made within the mutual fund family.

Investments in a fixed-rate or variable annuity grow and compound tax-deferred indefinitely. The only time income tax enters the picture is when withdrawals are made. At that time taxes are only paid on that portion of the withdrawal that is considered accumulated growth and interest. Money received that is considered return of principal is not taxable.

Performance

Variable annuities often perform better than the top mutual funds in the best performing bracket. Most mutual funds, because of their size, are forced to buy stocks and bonds that are not its first choice. The Securities and Exchange Commission (SEC) requires that the mutual fund follow diversification rules.

In contrast, a variable annuity has investments in specifically selected stocks and bonds. This is especially true in the case of an initial public offering (IPO). An IPO is a stock offered by a company that is going public for the first time. All mutual funds keep a certain amount of assets in cash. These assets in cash become reserves and are there to cover partial or complete liquidations. Fund managers do not like to sell off securities in order to settle partial or complete liquidations. This problem is not encountered with annuities since withdrawals are much less frequent.

Both annuities and mutual funds provide professional management. For the most part investors are not objective when it comes to making investment decisions. Professional money managers are excellent resources for the investor.

Withdrawal Options

Mutual funds and annuities permit withdrawals or complete liquidation at any time.

Investment Choices

A mutual fund family provides limited investment options and management styles from which to choose. Variable annuities offer a choice of many different management styles. However, mutual funds require investment money with the money managers within the mutual fund family.

Safety

Mutual funds are prohibited from guaranteeing the rate of return or even the safety of the principal. In a fixed-rate annuity the exact rate of return is known. No one has ever lost money in a fixed-rate annuity. The same cannot be said of mutual funds.

FREQUENTLY ASKED QUESTIONS

Why do mutual funds provide more information than annuities?

First, mutual funds are easier to understand. Popular publications emphasize the performance and features of mutual funds with much greater frequency.

Second, the brokerage industry can make more money selling mutual funds than annuities.

Third, the insurance industry does not spend as much money promoting annuities as fund executives spend promoting mutual funds.

Are there as many fund managers to choose from if I invest in an annuity rather than a mutual fund?

There are not as many portfolio managers under the annuity umbrella. However, it is possible to find a fund manager with a solid track record who manages according to

your investment objective. Annuity managers enjoy a better overall performance record than mutual fund managers do.

How can I compare mutual fund results to annuity results on a regular basis?

Financial publications such as *The Wall Street Journal, Barron's* and specialty services such as VARDS and Morningstar all provide fund and subaccount performance results for comparing and contrasting specific fund and annuity accounts.

What protection do I have against loss of my initial and/or ongoing investment?

Every variable annuity has inherent features that minimize risk and increase return, for example:

Professional management:
All variable annuities and family of mutual funds are monitored by professional investment managers. The managers, backed by education, experience and research, strive to achieve the stated objective and to select the right investments.

Diversification:
The risk is spread among many securities reducing the possibility of losing a substantial amount of money due to any security. Investments are made in more than one portfolio.

Separate accounts:
Variable annuity portfolios—other than fixed account option—are part of a separate account that is maintained and established aside from the insurance company's general investment portfolio. Only the performance of the separate account portfolio chosen will affect results.

Switching privileges:
Providing money is not moved too often, most variable annuities money to be moved among the portfolios, usually without charge. When interest rates or market conditions change, transfers among portfolios keep earnings high.

Guaranteed death benefit:
Variable annuities guarantee that in the event of death during the accumulation phase the beneficiary will receive the greater of the entire amount of the annuity premiums less withdrawals, or current value of the investment.

FOCUS POINTS

1. Common features shared by annuities and mutual funds include easy to invest in and easy to monitor.
2. Mutual funds and annuities have professional management and outstanding performance record.
3. Annuities and Mutual funds provide investment options and opportunities to increase the investment.
4. Both provide withdrawal options and offer dollar cost averaging.
5. Mutual funds and Annuities differ in the area of commission, taxation, performance, withdraw options, investment choices, and safety.
6. On Mutual funds commissions range from one to 8.5% and this commission is usually subtracted from the investment.
7. Fixed and variable annuities do not charge the investor a commission.
8. Mutual funds are subject to income tax generated by the securities.
9. Mutual funds are subject to capital gains realized when stocks or bonds are sold.
10. Mutual funds are subject to taxation upon the sale of shares.
11. Investments in a fixed or variable annuity grow and compound tax deferred indefinitely.
12. Variable annuities usually outperform mutual funds.
13. Mutual funds and annuities permit withdrawals or complete liquidation at any time.
14. A mutual fund family provide limited investment options and management styles.
15. Variable annuities offer a choice of many different management styles.
16. Mutual funds require investment money with the money managers within the mutual fund family.
17. Mutual funds are prohibited from guaranteeing the rate of return or the safety of the principal.
18. Fixed rate annuities guarantee an exact rate of return.

8

UNDERSTANDING ANNUITY TAXATION

BASIC ANNUITY TAXATION

Always urge customers to seek advice from a personal tax advisor. Insurance agents are not trained or qualified to provide tax advice. There are gray areas where even tax attorneys disagree. It is not an agent's role be a tax practitioner. An agent's role is to help people accumulate more money. Understanding basic annuity taxation allows an agent to perform that role.

Withdrawal

Withdrawals from annuities are taxed in one of two ways, depending upon when the annuity was issued.

Annuities issued prior to 8/14/82, were structured with FIFO accounting (first in, first out). Since principal was first in, it came out first, tax-free.

For annuities issued on 8/14/82 and thereafter, taxation changed to LIFO (last in, first out). Simply put, withdrawals are now taxable since interest is withdrawn first. Many customers will enjoy paying taxes only when interest is withdrawn since most are now paying taxes on interest even if they don't withdraw it.

Ten Percent Excise Tax Penalty

The government extends tax advantages to the annuity for retirement purposes. The government also extends tax disadvantages to taxpayers that do not use the annuity for

retirement. All interest withdrawn prior to the owner attaining the age of 59½ will be subject to a ten percent excise tax penalty.

SIX WAYS TO AVOID THE TEN PERCENT EXCISE TAX PENALTY

There are certain circumstances where the ten percent excise penalty may be avoided:

1. Disability of taxpayer;
2. Distribution from a pre-8/14/82 annuity;
3. Death of owner (but death of annuitant for annuities issued before 4/23/87);
4. Payment from an immediate annuity where benefits commence within one year of purchase;
5. Payment from a structured settlement; and
6. Substantially equal payments over taxpayer's life expectancy.

Exclusion Ratio

When and if the owner annuitizes (applies their annuity value toward a settlement option), the annuitant will receive equal payments. The contract owner does not pay full taxes on the payments like those incurred with withdrawals. An *exclusion ratio* is applied to each payment received. An exclusion ratio stipulates that a percentage of each payment is considered a return of the owner's cost basis and is tax-free. The balance is taxable.

Calculate the exclusion ratio by dividing the expected return into the total of all premiums paid into the contract.

> **Example**:
>
> Assume an annuity was purchased one year ago for $80,000. It is now worth $88,000. The total of all premiums paid in the contract equal $80,000. Further assume that the contract owner wants to annuitize and elects the settlement option of a 5 year Period Certain (60 months) where monthly payments will be $1,667.00 a month. The expected return is $100,000 ($1,667.00 multiplied by 60 months).
>
> Therefore, 80 percent of all payments to the contract owner are income tax free ($80,000 of $100,000 = 80%). For annuities using a life contingency, calculate life expectancy using government tables to determine the expected return.

Note that, effective with all annuity starting dates after 12/31/86, payments become fully taxable after the owner recovers the total of all premiums paid into contract (determined by adding all dollars excluded from taxes). In other words, after they have lived beyond

their expectancy (as calculated when payments began), payments then become fully taxable.

IMPORTANT TIPS FOR 1035(A) EXCHANGES

One unique tax advantage for annuities is the ability to transfer money from one annuity to another annuity income tax-free, as provided by Section 1035(a) of the Internal Revenue Code. Transfers under Section 1035(a) should be carefully reviewed.

1. Assign the old annuity contract (if premiums are non-qualified) to the new insurance company;
2. Exchange the entire annuity (cannot transfer some of the money);
3. If there are loans outstanding, repay loans before exchanging;
4. Parties designated in the old contract as owner, annuitant, and beneficiary, should be again be designated in the new contract; and
5. Customers should consult with their tax adviser before the exchange.

The basics to annuity taxation are:

- Taxes are only paid when interest is withdrawn.
- The 10 percent excise tax penalty exists just like another tax-advantaged vehicle, the IRA.
- The exclusion ratio allows clients to receive income partially income tax-free.
- Section 1035(a) exchanges are a way to move annuity money income tax-free.

FOCUS POINTS

1. The government extends tax benefits to an annuity for retirement purposes.
2. A 10% excise tax is imposed for withdrawal prior to age 59 ½.
3. The excise tax is waived at the disability or death owner.
4. Tax is waived when payment occurs from an immediate annuity with benefits commencing within one year of purchase.
5. Tax is waived from a structured settlement payment.
6. Tax is waived due to substantial equal payments over the taxpayer's life expectancy.
7. Partial tax is paid when an exclusion ratio formula is used.
8. Payments become fully taxable after an owner has recovered all of the premiums paid into the annuity.
9. Money transferred from one annuity to another is tax free under section 1035(a)
10. To qualify under section 1035(a) the old annuity contract must be assigned to the new company.
11. The entire annuity must be exchanged under a 1035(a).
12. All loans must be fully paid back under a 1035(a) exchange.
13. Parties in the first contract must be the designated parties in the second contract to qualify for a 10359(a).

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- Outline how withdrawals from annuities can be taxed
- Outline and discuss the six ways to avoid the ten percent excise tax penalty.
- How are 1035(A) exchanges executed.

9

GROUP PLAN ANNUITIES

TAX SHELTERED ANNUITIES (TSA)

Certain groups of people are eligible for Tax-Sheltered Annuities (TSAs). These qualified programs are approved under Section 403(b) of the Internal Revenue Code (IRC).

Qualifying individuals are:

1. School personnel;
2. Hospital employees; and
3. Members of non-profit organizations.

To quality for a TSA the individual ***must be*** a member of one of the three groups described above.

Tax-sheltered annuities offer many advantages not found in any other type of retirement plan or annuity. A tax-sheltered annuity has the following characteristics:

1. It is purchased from an insurance company;
2. The participant may choose either a variable or fixed account;
3. Contracts are issued to either an individual or group;
4. The insurance carrier receives deposits directly from the employer;
5. The participant's contributions may vary yearly;
6. Contributions are outlined in a salary reduction agreement;
7. Contributions are made via payroll deductions on a pre-tax basis;
8. Social Security tax (FICA) is withheld on the employee's salary deduction amounts; and

9. Under certain circumstances, money may be withdrawn without penalty, such as:
   A. Financial hardship
   B. Disability
   C. Death
   D. Termination of employment

INDIVIDUAL VS GROUP CONTRACTS

Under a group contract, the participant will receive an individual certificate verifying that they are in fact participating in the program. The actual contract is between the insurance company and the participant's employer. While individual contracts have certain guarantees that exist until that contract ends, group plans have guarantees that last for a certain period of time, such as five years.

Flexibility is the major difference between an individual and a group contract.

Individual contracts are totally portable. A participant who changes jobs under an individual contract has several options:

1. Freeze the account;
2. Transfer all of part of the program to one offered by a new employer, providing the new employer is eligible to participate in a TSA program; and
3. All or part of the monies may be transferred to an IRA.

If the changeover is properly made, there should be no tax consequences.

Variable Funds

In order for an insurance carrier to offer variable annuities it must be registered with the Securities and Exchange Commission (SEC). The insurance company is also required to provide the investor with a prospectus prior to the purchase. Since several variable contracts offer companion fixed-rate accounts the policyholder is allowed to transfer between the fixed and variable with little or no cost.

TAX BENEFITS OF A TSA

A TSA has attractive income tax implications:

1. Contributions made to a TSA reduce the participant's taxable income, dollar for dollar;

2. Once contributions are invested the participant's money will grow and compound fully tax-deferred; and

3. Participants making withdrawals when in a lower tax bracket can minimize tax consequences.

Accumulation Period

The accumulation period is the time in which the employer sets aside money into the TSA that has been deducted from the income of the participant.

The employer contributions are made with before-tax dollars by the following methods:

1. Bi-weekly;
2. Semimonthly; and
3. Monthly

The monthly schedule is the one most commonly used. The insurance company then deposits most, if not all, of each contribution into the participant's account. The money is invested to conform to the options the participant has elected. As a rule, when deposits are made a transaction charge may occur. There may also be a quarterly or annual maintenance fee.

Payout Period

When it comes time for the participant to receive money, usually at retirement, this is called the payout period. The participant may receive payout in a variety of ways:

1. Receive a lump sum;
2. Receive a partial payment;
3. Roll the account into an IRA;
4. Roll the account into a TSA; and
5. Annuitize the contract and start receiving monthly, quarterly or annual payments.

If the participant chooses to annuitize, the amount received will depend on:

1. The rate the insurance company is offering;
2. The annuity option selected; and
3. The actual amount being annuitized.

The rate the insurance company pay is based on a certain amount of monthly income per month for each $1,000.00 of cash invested in the annuity.

Crediting Interest

Two methods are used to determine the current interest rate credited to the participant's account:

1. The portfolio average; and
2. The banding method.

The portfolio average is a reflection of what the insurance company has earned on its entire portfolio of investments during the given year. From this, the insurance carrier forms a composite rate and the policy owners are credited with that amount.

The banding approach uses a year-by-year method of crediting accounts. In other words, the participant's contributions are banded together for that particular year. When interest rates are rising the banding method is best. When interest rates are declining the portfolio method is best.

Two-tiered Interest Crediting

This method is often misleading. The two-tier approach credits the contract with a lower rate of interest should the participant make a partial or total liquidation of the account. There is also a substantial charge for withdrawals and this charge may never disappear.

Under this method accounts are credited at an artificially low rate if a minimum payout or period is elected. Many states have outlawed two-tiered policies because they are considered to be unfair.

Current Trends in Crediting

Many companies have discontinued the use of a calendar-year approach in valuing the rate of interest credited to accounts.

Many companies use a quarterly, monthly and, in some cases, a daily method. This permits the insurance companies to be more competitive and also gives them the ability to move quicker to change the credited rate in the event that it is too high in comparison to the actual yield of the insurance company's portfolio.

Some insurance companies have adopted a provision known as *market value adjustment*. This method adjusts the fund balance, *not* the yield, upward or downward. The adjustment will always be in the opposite direction of the movement in interest rates.

Variable Options

The variable TSA is a good alternative to the more conservative fixed-rate TSA. The variable account offers the participant a range of options from aggressive stock portfolios to money market funds.

CONTRIBUTIONS

The majority of all TSA contributions are made by the employee. The amount of the contribution is governed by parameters set by the insurance company. Additionally, total contributions cannot exceed the IRS annual limit.

The amount that may be deducted from the employee's paycheck is calculated by using a dollar figure based on a percentage of pay. The amounts deducted are sent to the insurance company biweekly, semimonthly or monthly.

Transfers

Contributions may be made by transfer. Under this method the participant can move funds from one company to another, or from one subaccount to another offered by the same insurance company.

Transfers are made because:

1. The participant is dissatisfied with the current company's portfolio performance; or
2. The participant is changing employers; or
3. The participant has experienced a change that affects his ability to take risks; or
4. There is a change in the participant's retirement date; or
5. The participant has changed employment and the new employer does not have a TSA.

Retirement Options

Retiring participants have several options:

1. Leave the money in the account and let it continue to compound and grow until some future date;
2. Withdraw part of the money;
3. Withdraw all of the money;
4. Receive payments over a fixed period of years;

5. Select a fixed rate;
6. Select a variable rate;
7. Transfer the money to another insurance company; and
8. Roll over the money into an IRA.

Loans

Some insurance companies will permit participants to borrow a portion from the TSA, however not all permit loans. The IRS governs loans from TSAs via a series of codes that state the following:

1. A loan is taxable if it exceeds 100% of the employee's account or $10,000.00, whichever is less, if the account is less than or equal to $10,000.00.
2. A $10,000.00, or greater, loan will be taxed if the participant's account is more than $10,000.00 but less than $20,000.00.
3. If the value of the account is over $20,000.00, a loan will be taxable if the amount of that loan is 50 percent of the value of the account, or $50,000.00, whichever is less. The $50,000.00 amount referred to here is reduced by any net loan repayments made by the employee during the preceding 12 months.
4. Loans, with the exception of real estate related loans, must be repaid within five years.
5. Should the loan not be repaid in time, any amount that is still outstanding will be immediately subject to taxation. It may also be subject to a 10 percent tax penalty.
6. If a loan is in default, the insurance company is required to notify the IRS and the participant.
7. Should the loan ever exceed the value of the employee's account any excess is taxed?

Loan Protection

Since TSA loans do have the potential for adverse tax and penalty consequences, it is suggested the borrower contact his insurance company and discuss possible safeguards.

Protective measures should be taken to avoid a late payment, also known as a *technical default*. Since the insurance company may deduct any payments that are due from funds in the account, the participant could find himself in a withdrawal situation due to this forced payment.

Death Benefits

As a rule most insurance companies do not charge a fee for liquidation of an account due to death. Upon the death of the participant most companies pay out the total value of the account. The death benefit may be a lump sum or it can be annuitized by the beneficiary. As a rule, the processing time for death claims once the death certificate has been received is about two weeks.

TSA Expenses

Virtually every tax-sheltered annuity has expenses. Insurance companies obtain fees as:

1. Explicit; or
2. Implicit.

Explicit charges are clearly spelled out and visible. These charges may be applied regularly throughout the year under the following circumstances:

1. When the account is valued;
2. When a contribution is received;
3. When a loan is made; and
4. When a withdrawal takes place.

Implicit charges are made indirectly and can often be much higher than their explicit counterparts. An implicit charge may be the difference between the returns the insurance company actually earns versus the amount credited to your account.

Insurance companies do have the right to alter or amend a TSA contract. As a rule this privilege is very broad and can affect:

- The amount of any charges made;
- Interest credited to the account in the future;
- Annuity rates per $1,000.00 annuitized; and
- Other provisions in the contract.

Note: TSAs cannot be changed without the permission of the participant.

FREQUENTLY ASKED QUESTIONS

Are contributions to both a TSA and a regular annuity permitted?

Yes, although it is suggested that the majority of the contribution be invested in the TSA. By doing expenses and fees are kept to a minimum. There is no law against investing in both.

Why are the rates of return are so different with TSA accounts?

TSAs are group annuities. Because of the number of plan participants involved, expense and rate of return calculations are more complex.

Do TSAs differ from regular annuities?

The TSA is a type of annuity that can be offered only to certain employment classifications. A major difference is that TSAs contribute before-tax dollars and other annuities are funded with after-tax dollars.

What if I don't agree with a change in my group policy or contract?

When participating in a TSA the individual is subject to the decisions of the group as a whole. Although most changes are made with maximum input from individuals in a group plan, the final decision made by the group may not mesh with an individual's financial plans. The alternative for the individual: terminate participation.

FOCUS POINTS

1. Tax sheltered annuities are approved under Section 403(b) of the Internal Revenue Code.

2. Qualifying individuals are school personnel, hospital employees, and members on non-profit organizations.

3. Tax Sheltered annuities are purchased from an insurance company.

4. TSA contracts are issued to either an individual or group.

5. The insurance carrier receives deposits directly from the employer.

6. Tin TSA's the participant's contributions may vary from year to year.

7. In TSA's contributions are outlined in a salary reduction agreement and are made via payroll deduction on a pre-tax basis.

8. FICA is withheld on the employee's salary deduction amounts.

9. Money can be withdrawn without penalty under circumstances of financial hardship, disability, death, and termination of employment.

10. Under a group contract the contract is between the insurance company and the participant's employer.

11. Group contracts have guarantees that last a certain period of time, such as five years.

12. Flexibility is the major difference between an individual and a group contract.

13. Individual contracts are portable to another qualified employer, may be transferred to an IRA, or frozen.

14. Contribution's made to a TSA reduce the participant's taxable income dollar for dollar.

15. Employers may make contributions biweekly, semimonthly, or monthly.

16. Payout can be made in a lump sum, partial payment, rolled into an IRA, rolled into another TSA, or annuitize the contract.

17. Interest is credited by either the portfolio average or the banding approach.

18. Crediting of interest is usually done either monthly or quarterly.

19. Contributions are made by the employee through the employer.

20. Contributions are limited by IRS regulations.

21. Contributions may be made by transfer from one company to another.

22. The IRS governs loans from TSAs.

23. Loans with the exception of real estate related loans must be paid back within five years.

24. If a loan is in default the insurance company is obligated to notify the IRS.

25. A late payment or technical default could place a participant in a withdrawal situation.

26. A death benefit can be a lump sum or can be annuitized.

27. Charges on accounts are made either in an implicit or explicit manner.

28. TSA's cannot be changed without the permission of the participant

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- Who are qualified for TSA's.
- Name and outline the characteristics of Tax Sheltered Annuities.
- Outline the differences between individual contract and group contracts.
- What must an insurance carrier do in order to be able to offer variable rate contracts.
- What are the tax benefits of a TSA.
- Outline the five methods that may be used to receive funds during the payout period.
- Outline the two methods of crediting interest and what process does each follow.
- Discuss the two tiered interest credit method.
- What guidelines must be used in adding contributions to an annuity.
- Outline the eight retirement options of an annuity policy.

10

EQUITY INDEXED ANNUITIES

AN OVERVIEW OF EQUITY INDEXED ANNUITIES

Equity indexed annuities were first introduced in 1995 and met with such great success that by 1996 received wide acceptance.

The Equity Indexed Annuity offers the consumer, in a single tax advantaged annuity contract, a solution to balancing both risk and reward.

Since most Equity Indexed Annuities are fixed annuities today's products have not been registered as securities and maybe sold by licensed life/annuity agents.
Should a carrier introduce a variable format of Equity Indexed Annuity than such product would be registered and sold through securities-licensed representatives.

Equity Indexed Annuities combines guarantee of principle, minimum cash values, free withdrawals, surrender charges and tax deferral with crediting rates that are linked to the equity market.

GENERAL DEFINTION OF AN ANNUITY

As discussed previously an annuity is a financial product that serves the purpose of accumulating wealth on a tax deferred basis and provides a pre-arranged payout of income either for life, for a specified period, for an individual or for both individuals.

DEFERRED ANNUITY FEATURES

Interest is not taxed until withdrawn by the contract owner or beneficiary.

Retirement payout options include guaranteed life time payout or specified period payout to contract owner or beneficiary.

A long term retirement planning program as an option of the contact owner.

Availability of funds for emergency situations, should the need arise.

Except for variable annuities, the stability and consistency of earnings of both principal and interest

Probate free death benefit as a result of the annuity.

A surrender charge for early withdrawal with some annuities and an excise tax penalty for withdrawals made prior to age 591/2.

COMPARING ANNUITIES

In the case of fixed annuities the insurance carrier and the annuitant work with a specific interest rate and the annuitant is guaranteed both the rate of return and the principal amount of the contract. This type of contract normally carries the lowest risk and thus in most cases the lowest return.

In the case of variable annuities the contract owner enters into the risk factor by choosing the investment vehicles in which his principal and interest is invested. Thus by joining in the choice, he also joins in the risk and could experience both an increase or decrease in the amounts accumulated. The investment sources for variable annuities are usually a combination of mutual funds and equity funds.
This vehicle certainly represents an opportunity for higher gain over a fixed product but also an opportunity for greater losses.

Equity Indexed Annuities on the other hand have interest rates that are linked to growth in the equity market as measured by an index. The mostly commonly used index is the S & P 500.

Because the owner of the contract is guaranteed no exposure to the downside risk, the upside potential can represent great gain.

FEATURES OF EQUITY INDEXED ANNUITIES

Accumulations are taxed deferred until paid out to the contract owner or beneficiary.

They feature lifetime retirement income options and death benefits.

No market risk to owner on prior earnings and a guaranteed return of principle.

Structured under Non-Forfeiture provisions, minimum guaranteed surrender values.

Easy access to funds through free withdrawals.

In some cases, penalties are imposed for early withdrawals.

BENEFITS OF EQUITY INDEXED ANNUITIES

Both the principal and earnings are guaranteed.

A vehicle that permits both long term accumulation, as well as, retirement planning.

Earnings that have a history and are based on past market performance

Death benefits that are free of Probate

As time passes Equity Indexed Annuities are predicted to gain stronger favor because historically Equities have out-performed fixed income investments and inflation.

"SAFE HARBOR RULES" OF EQUITY INDEXED ANNUITIES

In order for an Equity Indexed Annuity to be outside the domain of the Security Exchange Commission regulations it must meet all the requirements which qualify it to be a fixed annuity.

These requirements include the stipulation that the contract not be marketed primarily as an investment.

That the excess interest credited is not modified more than once a year.

That the insurer credits a specified rate of interest at least equal to the minimum non-forfeiture interest rate

That the insurer guarantees principal and prior earnings
That the insurer assumes the investment risk

That the owner's account value is not based on a separate account.

That the indexed annuity be issued by a regulated insurer.

SECURITIES REGULATION ORGANIZATIONS

The two major players in this arena are The Securities and Exchange Commission and the National Association of Securities Dealers.

The Securities and Exchange Commission is an agency of the federal government that regulates the offerings of securities to the consumer. The Commission establishes rules and also enforces the securities laws that have been enacted by congress.
The National Association of Securities Dealers (NASD) is a self regulatory organization. NASDA oversees it's members activities, making sure that they are in compliance with federal laws and at the same time issues it's own rules and regulations. As the name implies the organization is made up of individuals in the security business.

Also playing a part in this picture is the broker/dealer and the registered representative.

The broker/dealer is a company or individual who has registered with the Securities and Exchange Commission to buy and sell securities for its own account or for the accounts of others.

A registered representative is an agent for a broker or dealer and represents the interest of that broker or dealer in working with a consumer.

PRE-REQUISITES OF SELLING VARIABLE EQUITY INDEXED ANNUITIES

In addition to having a life license an one must have become a registered representative of one's company broker or dealer. In order to become a registered representative, you must pass either the Series 6 or Series 7 examination covering the Uniform Securities Act. Some states also require an additional examination to sell registered contracts.

Sales activities in this area must be strictly supervised by the broker/dealer, and strict compliance to NASD rules and regulations are mandatory.

The necessity of these rules is for the purpose of providing prospects with accurate information before making a buying decision that involves risk.

Some of the most important rules to remember follow.

- A prospectus must be provided to each prospective consumer prior to the time of decision making. A prospectus summarizes the detailed statement previously filed with the Securities Exchange Commission.

- Any and all solicitations must be either preceded or accompanied by a prospectus.

- The prospect should be encouraged to read the prospectus and formulate his or her own decision.

Because of the strict sales rules, companies often times prepare brochures, pamphlets, and sales presentation folders that are provided to the sales agent as an assurance that all NASD rules have been followed.

An agent must use the highest ethics in presenting this type of product. It is important that no statements are made in regard to predicting losses or gain.

It is critical that a prospect not be made to believe that the product is sanctioned or approved by the Securities Exchange Commission. Your statement to the client must not go any further than to acknowledge that both the statement and the prospectus have been filed with the Securities Exchange Commission.

For the right individual Variable Equity Indexed Annuities offer stock market linked returns without risking the principal and at the same time enjoy tax deferred earnings.

WHAT IS INDEXING?

Indexing is the strategy that seeks to match the performance of a specified group of securities. The recognized market measure of this group is called an "index".

Most equity-linked products marketed in the United States are linked to the S&P 500.

The S&P 500 is used over other indexes because for one it is a United States Department of Commerce leading economic indicator.

It reflects the long-term growth potential of equity linked returns. Normally these type of equities out perform fixed-interest returns as well as inflation.

The 500 stocks in the index represent 70% of the total United States equity market. It is compromised of stocks from the New York Stock Exchange, the American Stock Exchange and NASDAQ.

The S&P 500include industrial, utility, financial, and transportation stock and is "market weighed". This means that each stock impacts the index in proportion to that stock's importance in the market.
The S&P 500 doesn't include dividends and is a widely used index in "passive investing".
"Diversified" Equity Indexed Annuities link their return to two or more indexes.
Foreign linked equity indexes include:

The Dax which is compromised off an index of 30 stocks on the Deutsche Stock Exchange

The Nikkei which is an index of 225 stocks on the Tokyo Stock Exchange

The Financial Times Stock Exchange which is an index of 100 stocks on the London Stock Exchange

Since "indexing" is a strategy that basically buys and holds for a period of time it tends to outperform an active trading strategy which is a buy low sell high strategy over shorter periods of time. In an activity strategy of investing one is always trying to outguess the market for quick profit

The main features of an indexed fund are low cost, consistent performance, predictability, proven success, and tax efficiency.

THE VOCABULARY OF EQUITY INDEXED SECURITIES.

The **Annual Reset Rate** is an indexing method used to measure growth annually and re-established each year as a basis for the following year.

Averaging is a method wherein the index starting point is based on an average value over a pre-established period of time rather than on a specific day. Sometimes this is also known as the "Asian" method in comparison to the European method.

The **Cape Rate** is the maximum allowed percentage value increase in one year.

The **Contract Value** is the minimum guaranteed cash value minus applicable surrender fees.

The **Deferred Annuity** is a contract that accumulates value and pushes forward the distribution to an alternate pre-established date.

The **Floor** is the minimum credited rate applied to the account value regardless of the index changes.

A **Free Withdrawal** is a pre-established amount that can be taken out without suffering carrier imposed surrender charges.

The **Index Benefit** is the amount of earnings credited to a Equity Indexed Annuity.
The **Index Growth** is the change in the value of the index from beginning point to end measuring point.

Liquidity is the ease at which funds are available within a contract.

The **Participation Rate** is the percentage of increase in the index that will be credited to the account value.

Point to Point is an indexing method in which index growth is measured between tow points in time. This can range anywhere between one year and some future point.

The **Probate Free Death Benefit** refers to the ability of a beneficiary to receive death benefits without having to go through the expense of probate.

The term **Real Return** is the return on the investment after the rate of inflation is deducted.

The **Spread Yield** is a flat percentage deduction from the growth to pay for administration costs.

The **Surrender Charge** is a fee that is imposed for early termination of a contract or for withdrawing funds from the contract.

The **Term** is that period of time in which a surrender penalty applies.

THE MAIN CATEGORIES OF EQUITY INDEXED ANNUITIES

The three main categories of Equity Indexed Annuities are **annual reset, point to point and high-water mark with look back.**

- **ANNUAL RESET**
  This format sets and resets the starting index point each year and credits and compounds interest annually.

- **POINT TO POINT**
  This format determines a starting point and then measures to the ending point and credits the percentage increase to the account. An example of this might be a staring point of 1000 and at the ending point of five years 1600. This is a 600 point gain. This gain divided by the starting point index of 1000 would result in a 60% increase. This figure would then be multiplied by the participation rate to determine the contract credit at the end of five years.

- **ANNUAL HIGH WATER MARK WITH LOOK BACK**
  This format is like the point to point except it does not deal with beginning point to end point, but deals with beginning point to a high point on an anniversary date. An example might be that starting point is 1000 year 2 it reaches 900 no credit and no loss to the account is incurred. Year three it reaches 1100. Now credit is made to the account for the increase. This continues until the next high point is hit on an anniversary date. Basically a contract is credited at high points only and the owner of the contract suffers no losses if on an anniversary date a low is hit.

AVERAGE FORMAT

Some Equity Indexed Annuities base their increases on the average over a predetermined period of time.

TAX DEFERRED QUALIFIED PLANS

- **(IRA) INDIVIDUAL RETIREMENT ACCOUNT**
  An individual may make a maximum contribution of $2000 or 100% of wages if less than $2,000.

- **(SEP) SIMPLIFIED EMPLOYEE PENSION**
  This plan is designed for small businesses. The employer contributes up to 15% of the employee's adjusted gross income up to a maximum of $22,500. The plan is owned by the employee, and he or she can have both an IRA or an SEP in the same year.

- **(SIMPLE) SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES**
  This program is limited to small businesses that employ no more than 100 persons earning more than $5000 per year. It can be set up either as an employer established IRA or 401(k) plan.

  Employees may elected to contribute a percentage of compensation up to $6000 per year, and employers must match each employee's contribution dollar for dollar up to 3% of the employees income or contribute 2% of compensation to the account of each employee.

- **(TSA or TDA) 403b ANNUITY and TAX SHELTERED OR TAX DEFERRED ANNUITY**
  This program is available to charitable organizations, public schools, hospitals and churches. 100% of pre-tax income can be directed to the plan, up to a maximum of $9,500 per year.

- **SECTION 457 DEFERRED COMPENSATION**
  This program is available to employees of public bodies such as municipalities, counties, and states. The investments are owned by the employer. The employer satisfies the benefit to the employee.
- **HR-10 or KEOGH PLANS**
  These programs are available to self employed individuals and sole proprietorships, S-Corporations and partnerships. A contribution of up to 25% of the earned income to a maximum of $30,000 can be made.

  Profit sharing program up to a maximum of $22,500 based or 15% of income.
  Under a money purchase plan each may contribute up to 25% of income.
  Also a paired program may be used which combines a profit sharing and money purchase plan.
- **CORPORATE DEFINED BENEFIT PLANS** …
  …are sponsored by the corporation, and ERISA controlled. The policy is owned by a trustee. The employee looks to the pension fund to satisfy the benefit.

FOCUS POINTS

1. Equity indexed annuities offer the consumer a solution to balancing both risk and reward.

2. Most equity indexed annuities are fixed annuities and can be sold by licensed annuity agents.

3. In the event that variable indexed annuities are formulated such product would be required to be sold through security licensed representatives.

4. Equity indexed annuities combine guarantee of principal, minimum cash values, free withdrawals, surrender charges and tax deferral with crediting rates that are linked to the equity market.

5. Interest is not taxed until withdrawn by the contract owner or beneficiary.

6. Retirement payout options include guaranteed life time payout or specified period payout to owner or beneficiary.

7. Availability of funds for emergency should the need arise.

8. Probate free death benefit.

9. Equity indexed annuities have rates that are linked to growth in the equity market as measured by an index.

10. The most commonly used index is the S& P 500.

11. Both the principal and earnings are guaranteed.

12. A vehicle that permits long term accumulation and retirement planning.

13. Earnings have history and past market performance.

14. In order for an equity indexed annuity to be outside the domain of the Security Exchange Commission it must meet "safe harbor requirements".

15. In order to meet "safe harbor" the contract cannot be marketed primarily as an investment, interest credit is not modified more than once a year, the insurer must credit a specified rate of interest at least equal to the minimum non-forfeiture interest rate.

16. Under "safe harbor" insurer must guarantee principal and prior earnings, as well as assume the investment risk.

17. Other conditions of "safe harbor" are that the indexed annuity be issued by a regulated insurer and that the owner's account value is not based on a separate account.

18. The Securities Exchange Commission is an agency of the federal that regulates the offerings of securities to the consumer.

19. The SEC establishes rules and enforces securities laws that have been enacted by congress.

20. The National Association of Securities Dealers (NASD) is a self regulatory organization that oversees its' members activities.

21. A broker/dealer is a company or individual registered with the SEC to buy and sell securities for its' own or others account.

22. A registered representative is an agent for a broker or dealer assigned to work with a consumer.

23. To be a registered representative of a company an individual must have a life license and have passed either the Series 6 or Series 7 examination. Some states also require an additional examination to sell registered contracts.

24. A prospectus must be filed with the SEC and a copy provided to each prospective customer.

25. The prospect should make his decision based on the prospectus and not on agent recommendations.

26. No statements should be made in predicting loss or gain.

27. The prospect should not be lead to believe that the product is sanctioned by the SEC.

28. Indexing is the strategy that seeks to match the performance of a specified group of securities.

29. The S&P 500 is used as the preferred index because it is a United States Department of Commerce leading economic indicator.

30. The 500 stocks in the S&P represent 70% of the total United States equity market.

31. The S&P 500 doesn't include dividends and is a widely used index in "passive investing".

32. "Diversified equity indexed annuities link their return to two or more indexes.

33. Foreign linked equity indexes include the Dax, the Nikkei, and the Financial Times Stock Exchange.

34. The main features of an indexed fund are low cost, consistent performance, predictability, proven success, and tax efficiency.

35. The three main categories of Equity indexed annuities are annual reset, point to point, and high water mark with look back.

36. SEP- Simplified Employee Pension Plan is designed for small businesses.

37. Savings incentive Match Plan For Employees (SIMPLE) can be set up either as an employer established IRA or 401(k).

38. TSA OR TDA 403b Annuities are available to charitable organizations, public schools, hospitals and churches.

39. Section 457 Deferred Compensation programs are available to employees of public bodies such as municipalities, counties, and states.

40. HR-10 or Keogh Plans are available to self-employed individuals and sole proprietorships, S-Corporations and partnerships.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate sheet of paper outline your perceptions of the following thought provoking issues.

- What is the general definition of an Annuity.
- Outline the features of a deferred annuity.
- Outline the features of an equity indexed annuities.
- What are some of the benefits of equity indexed annuities.
- Discuss the “safe harbor” rule of equity indexed annuities.
- What are the pre-requisites of selling variable equity indexed annuities.
- What is indexing and how does it work.
- Outline and explain the three main categories of equity indexed annuities.

11

SUMMING UP THE ANNUITY

QUICK QUESTIONS AND ANSWERS

What is a Tax-Deferred Annuity?

It is a tax-advantaged product issued by an insurance company where long term financial needs can be addressed more efficiently than with most other financial alternatives.

What is the Major Advantage with Annuities?

Interest (earnings) accumulates income tax-deferred until dollars are withdrawn. This helps the customer build a substantial fund for retirement and can provide the customer with an income that he cannot outlive.

Is the Annuity a Safe Alternative?

The general assets of the insurer, which issues the annuity, back their annuity value.

Who Wants an Annuity?

Customers who want a safe way to reduce taxes; customers who want to decide when to pay taxes.

Who is the Average Annuity Purchaser?

Average age is 55 years old with an average premium of $20,000. Typically the annuity purchaser is not spending immediately the interest earned on his taxable alternative.

What Kind of Dollars are Invested in an Annuity?

Maturing CD's, passbook savings, money markets and treasury bills.

Is the Annuity for Everyone?

No, Dollars earmarked for short-term needs should not be invested in an annuity. In addition, at least, six months' worth of income should be on deposit outside of the annuity. Those who need current income should not consider the deferred annuity. On the other hand, those looking for one of the safest ways "to accumulate" dollars on a tax advantaged basis will find the deferred annuity extremely beneficial.

Does the IRS Impose a Ceiling on Investments in a Tax-Deferred Annuity?

No, the government imposes no ceiling, nor does an individual need earned income to qualify for the annuity. However, since the tax-deferred annuity is designed as a retirement supplement, the government does impose a 10 percent excise tax penalty on "pre-tax dollars" withdrawn before age 59½.

Since a Withdrawal of Principal is Tax-Free and IRS Penalty-Free, Can Principal be Withdrawn First and Then Interest?

No, the government considers interest earnings come out first. Naturally, any portion of a withdrawal exceeding interest earned would be a tax-free return on principal.

What is the Annuity is Paying an Interest Rate Less than Other Financial Alternatives?

Compare the virtually no-risk feature of the annuity to other alternatives. Note that the interest on many alternatives currently is taxable every year. And, Section 1035(a) of Internal Revenue Code allows annuity owners to transfer funds from one annuity to another annuity income tax-free.

How it the Interest Rate Declared After the Initial Guarantee Period of 1 to 3 Years?
Current market conditions and the insurance company's portfolio will dictate renewal rates.

How Does a Customer Know the Annuity Balance?

The insurance company will provide a statement of annuity value once a year.

When Does the Annuity Mature?

Although an annuity is similar to many safe taxable alternatives in many respects, an annuity does not mature after the initial interest rate guarantee period. Interest continues to accumulate on principal until the annuity is surrendered or when a settlement option is elected.

Will the Annuity be Tied Up in Probate Proceedings?

No, if a "named" beneficiary, other than the estate, is listed, annuity dollars will avoid the delay and expense of probate.

Will the Beneficiary be Taxed on the Interest That Accumulates in the Annuity?

Beneficiaries will be taxed on the tax-deferred interest when receiving those dollars. However, if a beneficiary is the spouse of the contract owner and the contract owner dies, the beneficiary may elect to continue the annuity and postpone taxes if the contract owner dies. Once again, the customer decides when to pay income taxes. If the beneficiary is not the spouse and the owner dies, then dollars must be totally withdrawn within five years or they may be received over the beneficiary's life expectancy. However, this latter option must be elected during the first 12 months following the contract owner's death.

Is the Annuity Identical to an IRA?

Although the annuity can be used as a funding vehicle for an IRA, the purpose of an annuity is directed to after-tax dollars. Therefore, dollars deposited into the annuity are not deductible. And because of this, there is no government imposed ceiling on how much premium can go into an annuity, nor do distributions have to begin at age 70½. Some say that the annuity picks up where the IRA leaves off.

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DEFINITIONS USED IN ANNUITY PLANS

A

Annuitant -One who receives an annuity payout.

Annuity-A contract that pays an income for life or for a specified period.

B

Beneficiary - A person who may become eligible to receive, or is receiving, benefits under an insurance plan, other than as an insured.

Beneficiary, Irrevocable - A named beneficiary whose status as beneficiary cannot be changed without his or her permission.

Beneficiary, Primary - The person first designated to receive the proceeds of a policy, as named in the policy.

C

Cancellation - Termination of the insurance contract by voluntary act of the insurer or insured, effected in accordance with provisions in the contract or by mutual agreement.

Claim - The demand of an insured or his or her representative or beneficiary for benefits as provided by an insurance policy.

Commission - The portion of the premium stipulated in the agency contract to be retained by the agent as compensation for sales, service, and distribution of insurance policies.

Contingent Annuity - Annuity structured so payments are contingent upon the occurrence of an uncertain event.

Contingent Beneficiary - Person or persons named to receive benefits if the primary beneficiary is not alive at the time the insured dies.

D

Death Benefit - The policy proceeds to be paid upon the death of the insured.

Death Claim - A formal request for payment of policy benefits occasioned by the death of the insured. Should be made through the agent, but may be made directly to the home office. Requires a copy of the death certificate as proof of death and is made by the beneficiary.

Deferred Annuity - An annuity for which payments to the annuitant are delayed until a specified future date.

Domestic Company - An insurer formed under the laws of the state in which the insurance is written.

E

Effective Date - The date on which an insurance policy goes into effect.

Estate - Assets of an individual comprising total worth. Includes any life insurance in force.

Expiration - The date upon which a policy's coverage ceases.

F

Fixed Amount Option - A settlement option under which the beneficiary receives a fixed amount for an unspecified period of time. Payments continue until the principal and interest are depleted.

Fixed Period Option - A settlement option under which the beneficiary receives a regular income for a specified period of time.

Flexible Premium Annuity - An annuity that allows the contract owner the option to pay or not pay the annuity premiums following the establishment of the annuity. Commonly used in conjunction with an Individual Retirement Account.

Fraud - An intentional misrepresentation made by a person with the intent to gain an advantage and relied upon by a second party which suffers a loss as a result.

H

Home Office - The place where an insurance company maintains its chief executives and general supervisory departments.

I

Immediate Annuity - An annuity in which the income payments to the annuitant are to begin almost immediately -- after a period of time equal to the period between payments has elapsed.

Insurance Department - A governmental bureau in each state or territory (and federal government in Canada) charged with administration of the insurance laws, including licensing, examination, and regulation of agents and insurers. In some jurisdictions, the department is a division of some other state departments or bureau.

Interest - That which is paid for the use of money by the user.

J

Joint Life Annuity - An annuity under which payments are made to two annuitants for only as long as both live. When one dies, payments cease even if one remains living.

L

Lapsed Policies - A policy for which the policyholder has failed to make the premium payment during the grace period, causing the coverage to be terminated.

Life Annuity - An annuity that provides a periodic income to the annuitant during his lifetime.

Life Annuity with Period Certain - An annuity under which the annuitant receives payments for a specified number of years or for his lifetime, whichever is longer. If the annuitant dies before all the guaranteed payments have been made, the beneficiary receives the payments for the rest of the certain period.

Loan Value - The amount of cash value reposing in a policy which may be borrowed by the insured.

M

Mortality Rate - The average number of people who die each year.

P

Policy - The contract effecting insurance and including all clauses, riders, endorsements, and papers attached to and made a part of the contract.

Primary Beneficiary - The beneficiary named first to receive proceeds or benefits of a policy that provides death benefits.

R

Rebate - Giving or offering to give something of value other than the benefits of a policy as an inducement to buy insurance, an illegal practice.

Refund Life Annuity - Provides annuity payments for the annuitant's lifetime with the guarantee that in no event will total income be less than the purchase price of the contract. If the annuitant dies before receiving this amount, the difference is paid to a named beneficiary.

Retirement Annuity - Generally a deferred annuity under which payments are made by the annuitant until retirement age.

Rider - An amendment attached to a policy that modifies the conditions of the policy by expanding or decreasing its benefits or excluding certain conditions from coverage.

S

Settlement Option - A method of receiving life insurance proceeds other than in a lump sum.

Straight Life Annuity - (*See* Life Annuity).

T

Temporary Annuity Certain - The annuitant receives payments for a specified number of years. If the annuitant dies after the payments have started, the beneficiary receives the payments for the rest of the specified number of years.

V

Variable Annuity - Annuity whose payment varies with the fortunes of the investment.

W

Waiver of Premium Provision - When included, provides that premiums are waived and the policy remains in force if the insured becomes totally and permanently disabled.

PUBLISHER'S NOTE

Important Notice

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AHI CE SERVICES
10115 W GRAND AV
FRANKLIN PARK, IL 60131
TOLL FREE: (800) 894-2495
(847) 455-5311
FAX: (847) 455-5339
INTERNET: WWW.AHICE.COM
EMAIL : INSURANCE@AHICE.COM