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Variable Annuities

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What is a variable annuity?

Investor assumes risk of investment return

A variable annuity is a type of annuity that has a variety of investment options (called subaccounts) available for your selection. When you purchase a variable annuity, the annuity issuer offers you a choice of investment portfolios into which you can allocate your premiums. The investment choices may include general equity stocks, balanced portfolios, bonds, and other specialty investments, such as international stocks. Unlike a fixed annuity in which the issuer guarantees that a minimum rate of interest will be paid on your investment in the annuity, the issuer of a variable annuity does not guarantee or project any rate of return on the underlying investment portfolios. You, as the purchaser of the annuity, assume all risk on the underlying performance of the investment subaccounts that you select. Your return may be greater than or less than that of a fixed annuity.

Caution: *Variable annuities are long-term investments suitable for retirement funding and are subject to market fluctuations and investment risk including the possibility of loss of principal. Variable annuities contain fees and charges including, but not limited to mortality and expense risk charges, sales and surrender (early withdrawal) charges, administrative fees and charges for optional benefits and riders. Variable annuities are sold by prospectus. You should consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the variable annuity, can be obtained from the insurance company issuing the variable annuity or from your financial professional. You should read the prospectus carefully before you invest.*

Most issuers of variable annuities offer several investment options

Nowadays, most variable annuity issuers offer investors several different variable subaccounts in which they can invest all or a part of the premiums they pay into the annuity. Most issuers will offer at least the following different types of investment portfolios: (1) a money market subaccount; (2) a government securities subaccount; (3) a corporate bond subaccount; (4) a high-yield bond subaccount (5) a balanced subaccount made up of both stocks and bonds; (6) a common stock subaccount; (7) a growth and income subaccount; and (8) a guaranteed subaccount (in which the annuity issuer guarantees a minimum rate of interest) that is similar to a fixed annuity.

When you purchase a variable annuity, you can choose how your premiums will be allocated among the various subaccounts. Most issuers also allow you to transfer funds between portfolios. Many issuers also offer an asset allocation option that automatically reallocates your investments in line with a predetermined formula.

Distribution payments after annuitization may be either fixed or variable

When the time comes to start receiving the annuitized distribution payments from the variable annuity, you have a choice as to the type of payout you would like to receive. You can receive either a fixed payout, you can receive a variable payout, or you can receive a combination of the two. If you select a fixed payout, then the annuity issuer will make a series of identical payments to you. The amounts from one payment to another will not vary. If you select a variable payout, then the amounts paid to you can vary from one payment to another. The amount of each payment will depend on the underlying performance of the investment portfolios in which your annuity is invested. If the portfolios increase in value, then your payments will increase as well. Similarly, if the portfolios decrease in value, then the annuitized payments to you will decrease as well. Finally, most annuity issuers allow you to split your benefit payments between a fixed portion and a variable portion. By choosing this last option, you can be certain that you will receive a fixed amount for part of each payment and have the possibility of an increasing or decreasing amount for the other part of the payment.

When should you buy a variable annuity?

Want potential for greater returns than with a fixed annuity

A variable annuity can be a good choice for someone who is willing to risk the loss of their capital in return for the possibility of above-average returns. Unlike a fixed annuity in which the minimum, fixed rate of interest is known right from the beginning of the investment, the return on a variable annuity is dependent on the performance of the investment subaccounts selected. Thus, if you invest in equity-type subaccounts that perform well, your return may be substantially higher than what you would have received from a fixed annuity. Of course, there is also the risk that if the portfolios perform poorly, you may lose money. Variable annuities have become increasingly popular in recent years as people have sought the potential for higher returns.

Want to invest money tax deferred

A variable annuity is an excellent vehicle for people who would like to invest money on a tax-deferred basis and have already contributed the maximum amounts to other available tax-advantaged vehicles (e.g., 401(k) plan, IRA). As with other types of annuities, the earnings on a variable annuity are not taxed until you begin to withdraw the assets from the annuity. Thus, your investment in a variable annuity can grow tax deferred for many years. Over a long period of time, this tax-deferred growth of your investment can result in a substantially larger amount of money than a comparable taxable investment.

Variable annuities usually suitable only for people with long time horizon

A variable annuity can be a good investment only for people who are willing to keep their money invested for a long period of time. Most annuity issuers have a back-end surrender charge if you withdraw more than a small percentage of your money from the annuity during the first 3-10 years. The annuity issuer will typically allow you to withdraw 10 percent of your money without a penalty. However, if you want to withdraw more than this amount, then the issuer will usually impose a high surrender charge. In the early years (the first 3-5 years), the surrender charge may be as high as 10 percent of any amount (above the 10 percent) that you withdraw from the annuity.

Furthermore, when you withdraw money from an annuity contract entered into after August 13, 1982, the withdrawals are treated as coming first from earnings (and are fully taxable) until the investment earnings have been exhausted. (Note: if the annuity contract was entered into prior to August 14, 1982, withdrawals may be treated as first coming out of nontaxable investment in the contract and then out of earnings.)

Finally, if you withdraw any money prior to the age of 59½, you may be subject to a 10 percent penalty on top of whatever other taxes must be paid. Thus, a variable annuity will usually not be a good investment for someone who may need the money in the annuity in the near future. You should plan to leave your money invested in the annuity for a minimum of 10-15 years and not plan to begin withdrawals before the age of 59½.

Would like to receive payments for the remainder of your lifetime

You may also want to purchase a variable annuity if you would like to receive payments from the annuity for the remainder of your lifetime. One of the unique features of an annuity is an option to elect to receive the annuity payments over the entire course of your lifetime. Unlike other types of investments, if you choose this option you cannot outlive the annuity payments (although choosing this option reduces the amount of your payments). The annuity issuer must continue to make payments to you for your entire lifetime. Even if you begin to receive the annuity payments when you are 65 and live to 100 years of age, the annuity issuer must continue to make the payments to you.

What are the strengths of variable annuities?

May have above-average returns

Probably the main advantage to purchasing a variable annuity is that you have the potential to realize above-average gains from your investment (as compared to a fixed annuity). Unlike a fixed annuity in which the annuity issuer guarantees that a minimum amount of interest will be paid on your annuity investments (and this interest rate is usually quite low), the gains on a variable annuity are tied directly to the performance of the underlying investment portfolios that you select.

Can invest in different types of investment portfolios

Most annuity issuers offer different portfolios in which you can place your annuity money. The portfolio can range from money markets to all types of equity to a variety of bonds. Many annuity issuers also will offer a portfolio called a guaranteed account. A guaranteed account is similar to a fixed annuity in that the annuity issuer guarantees to pay a specific interest rate for a period of time on funds that are invested in this account, since the funds are part of the issuer's general account.

Caution: *Guarantees are subject to the claims-paying ability of the annuity issuer.*

Can move investments without incurring charges

Almost all annuity issuers will allow you to move your money from one subaccount to another subaccount without incurring commissions or other charges. Furthermore, switching money from one portfolio to another is not considered to be a taxable event, and thus, you will not owe taxes or penalties if there are gains in one or more of the subaccounts.

Example(s): *John purchases a $100,000 variable annuity when he is 45. Initially, he allocates 70 percent of the money to an aggressive growth equity portfolio and 30 percent to a growth and income portfolio. John would now like to reallocate the money to more conservative portfolios because he plans to retire at age 62. John can switch some or all of his money to different portfolios offered by his annuity issuer without paying any commissions or other charges. John will also not owe any taxes or penalties on the gains in the equity portfolios when he reallocate the funds to new portfolios.*

Earnings of variable annuity are tax deferred

Like other types of annuities, the earnings on money you invest in a variable annuity are not taxed until you begin to withdraw money from the annuity or receive distributions. At that point, you may be in a lower tax bracket than during the accumulation phase. Additionally, over a long period of time, this tax-deferred compounding can result in substantially larger gains than a comparable taxable investment.

Cannot outlive distributions if annuitization is selected over your entire lifetime

Another strength to a variable annuity (as well as to other types of annuities) is that you cannot outlive lifetime annuitized payments from the annuity. As long as you elect to receive the annuity payments over your entire lifetime, then the annuity issuer must make the annuity payments to you for your entire lifetime (although, choosing this option will lower your annuity payments). If you begin receiving the annuity payments when you are 65 and you live to be the age of 100, then the annuity issuer must make the payments to you for the entire 35 years. You cannot outlive the stream of payments. With other types of savings and investments, there is no guarantee that the invested money will last for your entire lifetime.

Can invest unlimited amount in a variable annuity

Unlike qualified retirement plans such as a 401(k) or an IRA, there is no limit to how much you can invest in a variable annuity.

Guaranteed death benefit

A variable annuity has a death benefit. If you die before annuitization begins, then the annuity issuer generally must pay to your beneficiary at least 100 percent of all your purchase payments (minus withdrawals and prior applicable surrender charges). If the contract provides, your beneficiaries may receive the cash value of the annuity, if greater.

Example(s): *You purchase a $50,000 variable annuity and place all the money in a small-capitalization equity portfolio offered by the annuity issuer. You die one year later. Because of a sharp downturn in the stock market, the account's value is $35,000 at the time of your death. However, your beneficiary will receive $50,000 (or 100 percent of the invested funds). If the portfolio had been worth $60,000 at the time of your death, and the contract so provided, then your beneficiary would have received the $60,000. Keep in mind that this example is for illustration purposes only and does not reflect actual returns of any variable annuity.*

Caution: *Guarantees are subject to the claims-paying ability of the annuity issuer.*

Guaranteed living benefits

For an additional cost, some variable annuities offer guaranteed living benefit riders which can help protect income, principal, or withdrawals during your lifetime. Guaranteed living benefits can help protect your investment during downturns in the market, which may be an attractive option to risk-averse individuals.

There are three basic types of guaranteed living benefits; guaranteed minimum income benefit (GMIB), guaranteed minimum accumulation (or account) benefit (GMAB), and guaranteed minimum withdrawal benefit (GMWB).

A GMIB rider guarantees a minimum income when the annuitization option is elected. Income is calculated on a "benefit base," which is your premium payments accumulated at a minimum annual compounding rate (typically four to six percent). The benefit base is not the same as the annuity contract's market value or cash value; it is used merely to calculate the amount of the income payments. A waiting period of up to ten years is commonly required before the implementation of the guaranteed payments, and other restrictions may apply.

A GMAB rider guarantees your initial investment. This rider promises that your contract will not fall below a minimum amount (typically your total premium payments less withdrawals, sometimes with a minimum rate of interest) after a specified number of years (typically ten years). So even if investment losses are incurred, you will at least get your original investment back. Annuitization is not required with this rider as it is with a GMIB rider. However, the annuity owner cannot take current income until the waiting period has expired, and many insurers reserve the right to allocate your assets to specific subacccounts. Other restrictions may also apply.

A GMWB rider guarantees a return of principal over time through withdrawals. Withdrawals of a fixed percentage (typically five to seven percent) for a specified number of years (typically 14 years) can be made until your entire amount of paid premiums has been withdrawn. There may be a waiting period of up to five years before withdrawals can begin, and other restrictions may apply.

A GLWB rider guarantees a minimum income payment without annuitization of the contract. Usually this rider provides for a minimum rate of return prior to exercising the rider. At the time you activate the rider, your payments are based on the greater of the annuity's accumulation value or the minimum income value.

Caution: *Guarantees are subject to the claims-paying ability of the annuity issuer. Guaranteed living benefits may be wasted if the guarantee is not utilized; the costs incurred for such benefits should be carefully considered.*

Distribution options

Another advantage to a variable annuity is that you have a choice of distribution plans available to you. You can withdraw amounts at your discretion (and maintain control of the principal) or you can choose one of the annuitization options. If you choose one of the annuitization options, you can receive a series of installment payments for a set period of time, or you can receive installment payments over your entire lifetime. With a variable annuity, you also have the choice to receive either fixed payments or variable payments. If you elect fixed payments, then you will receive the same amount for each payment. If you elect variable payments, then the amount you receive each time will vary depending on the performance of the underlying investment portfolios.

Variable annuities usually not subject to probate

If you die before the distribution period begins for your variable annuity, the proceeds in the annuity will go directly to your beneficiary (or beneficiaries) without being subject to probate . Because of the time delays and costs potentially associated with probating assets, it is generally advantageous not to have your assets pass through probate.

What are the tradeoffs to variable annuities?

No guaranteed rate of return other than for a guaranteed subaccount

Probably the main tradeoff to a variable annuity is that there is no guaranteed rate of return on your investment except for funds invested in a guaranteed subaccount. In fact, you may lose money on your variable annuity. Unlike with a fixed annuity, the issuer of a variable annuity does not guarantee any minimum rate of return. You, as the purchaser of the annuity, assume all of the investment risk on a variable annuity. If you elect to invest your variable annuity in equity portfolios and those portfolios decline in value, then you may lose money on your investments. For this reason, you should only consider purchasing a variable annuity if you are willing to assume the investment risk inherent in investing.

High fees and charges

Almost all issuers of annuities charge a variety of fees for the administration and management of an annuity account. Because variable annuities have more features than fixed annuities, variable annuity fees are generally higher, but in either case, fees can be costly.

Although the amounts may vary among issuers, there is usually an annual administration fee, an investment advisory fee, and a mortality and expense risk charge. The administrative fee (sometimes called a contract fee) is an annual fee (usually about $35) charged by the annuity issuer for the costs of administering the account. The money manager will usually also charge an investment advisory fee for the costs in managing the money in each investment portfolio. The mortality and expense risk charge (called the M & E charge) is imposed by the issuer to compensate for some of the guarantees that it makes (such as the guaranteed death benefit). The annual M & E charge may be 1.25 percent (or higher) of the assets in the variable annuity.

High surrender charges and early withdrawal penalties

Another tradeoff to variable annuities (as well as to other types of annuities) is the high surrender charges and early withdrawal penalties that may be imposed if you withdraw your money in the early years of the annuity. Most annuity issuers allow you to withdraw a small percentage of the funds (usually about 10 percent) in the annuity each year without a surrender charge. However, if you want to withdraw more than this amount from your annuity, most issuers will charge you a surrender charge in the early years of the annuity. The surrender charge may be as high as 5 percent to 7 percent in the first years of the annuity. Furthermore, if you withdraw money from the annuity before the age of 59½, you may be subject to a 10 percent penalty on all early withdrawals (in addition to the normal income tax that is owed).

Variable annuities not good short-term investments

Because of the substantial fees and expenses, early surrender charges, the onerous tax treatment of early withdrawals, and the penalty tax that generally applies to withdrawals before the age of 59½, variable annuities are typically only good investments for people who can invest money for the long term. If you will need the money in five years to pay for your child's college education or if you may need the money in an emergency, then you probably should not invest in a variable annuity.

What are the tax implications of variable annuities?

Accumulated earnings tax deferred

A variable annuity's earnings accumulate tax deferred. The tax deferral of earnings is an advantage for a variable annuity versus other taxable investments. As noted, there is tax-deferred compounding of the money you invest in a variable annuity. Earnings on your original investment compound tax deferred. Earnings on the interest then compound tax deferred.

Caution: *All annuity earnings are taxed as ordinary income when withdrawn.*

10 percent premature distribution penalty tax

To prevent individuals from using annuities as short-term, tax-sheltered investments, the tax code imposes a 10 percent penalty on premature distributions from the annuity. This penalty tax is in addition to the regular tax due on the distribution and will generally apply if an individual makes a withdrawal before the age of 59½. There are exceptions to this penalty tax. For example, the penalty will not be imposed if the annuity owner becomes disabled or dies before turning 59½. More importantly, the penalty will not be imposed if the withdrawals begin before the age of 59½ and they are a part of a series of substantially equal periodic payments made for the entire life of the owner (based on the life expectancy of the owner). Furthermore, the penalty applies only to the portion of the distribution that is subject to regular income tax.

Example(s): *Pete surrenders his variable annuity for $100,000 when he's 50 years old. Pete does not qualify for any of the exceptions to the 10 percent penalty tax. Out of the $100,000 withdrawal, $60,000 must be included in his taxable income. The penalty applies to the $60,000, and Steve will thus owe $6,000 in penalty taxes (in addition to whatever regular income tax he owes on the $60,000).*

Annuitization payments are partially a tax-free return of principal and partially taxable income

Once you begin to receive annuitized payments from the variable annuity, part of each payment you receive is treated as a tax-free return of principal, and the remaining part is treated as taxable income. However, unlike a fixed annuity, you do not calculate an "exclusion ratio" for a variable annuity. Because you cannot predict what the expected return will be on a variable annuity, you must instead calculate how much you have invested in the annuity. The amount of each payment you can then exclude from your taxable income is your invested amount divided by the number of years that it is anticipated that payments will be made to you. The remainder of each annuity payment must then be included in your taxable income.

Caution: *If the starting date for your annuity payments is after December 31, 1986, then the total amount that can be excluded from your taxable income is the amount you have invested in the annuity. After you have recovered your investment in the annuity, then the full amount of each annuity payment in the future must be included in your taxable income.*

Example(s): *Steve invested $100,000 in a variable annuity. He begins to receive annuitization payments when he retires at age 65. Steve's remaining life expectancy at age 65 is 20 years. Because it is a variable annuity, Steve is not sure exactly how much he will be paid each year. To figure out how much he can exclude from income each year, Steve must divide $100,000 by 20 years (or $5,000 per year). Any remaining amounts paid to Steve each year must be included in his taxable income. If Steve receives $10,000 in a given year, $5,000 of this payment must be included in his taxable income. Steve can exclude the $5,000 per year only up to the point at which he has fully recovered his investment in the annuity. Thus, if Steve lives for more than 20* *years, then the full annuity payment must be included in his taxable income after that point.*

Value of variable annuity contract may be included in your gross estate for estate tax purposes

The value of a commercial annuity will be included in your gross estate for estate tax purposes if (1) any beneficiary receives an annuity or other payment by reason of surviving you under any agreement, and (2) under that same agreement, you received or had the right to receive an annuity or payment (either alone or with someone else) for your life, for any period not ascertainable without reference to your death, or for any period that does not in fact end before your death.

Because only annuities where someone receives a payment by reason of surviving you are included in your gross estate, an annuity that expires at your death (such as a single-life annuity) will not be included in your gross estate. However, any payments from your annuity that you received during your life that you still own at your death (that you didn't transfer or consume) will be included in your gross estate.

The two requirements (payment to a surviving beneficiary and your own right to payments) may be met if you die before the annuity payments have begun or if you die after you have received payments. In either case, the amount included in your gross estate will be the value of the annuity as of the date of your death.

Example(s): *Jane is 50 years old and had purchased a variable annuity five years ago. The annuity is scheduled to begin making payments to Jane when she reaches 65, but Jane dies when she's 60. The annuity pays Jane's estate the current value of the annuity. This value must be included in Jane's taxable estate, even if the death benefit is payable to another beneficiary.*

Example(s): *Now assume Jane reaches the age at which the variable annuity purchased 10 years ago is scheduled to begin making payments. Jane selects the straight life settlement option whereby she will receive a variable amount of money each year for the rest of her life. Jane dies 3 years later. Because her annuity payments stop at her death, there is nothing to include in Jane's taxable estate. However, if Jane had selected a joint and survivor annuity payout with her spouse, John (whereby the payments would be made over both their lives), then the value of the payments to John after Jane's death would have to be included in Jane's taxable estate.*

Taxation of annuities very complicated

Both the income and estate taxation of variable annuities are very complicated. See a tax professional for more information.

IMPORTANT DISCLOSURES

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