

Insurance Facts
for Pennsylvania Consumers

A Consumer's Guide to
Annuities

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Pennsylvania Insurance Department Web site

Glossary of Terms

<i>Accumulation phase</i>	The period of time prior to the start of annuity payments where the premiums paid under an annuity contract are accumulated with interest.
<i>Accumulation Value</i>	The amount of money, consisting of premiums paid, any expense charge deductions and interest credited, that accumulates under an annuity contract during the accumulation phase.
<i>Annuitant</i>	The person who receives periodic payments under an annuity contract. This person is not necessarily the same person who made the original purchase payment.
<i>Annuity</i>	A contract that provides for the periodic payment of money. It is designed to pay benefits while a person is living.
<i>Annuity Payment Period</i>	The length of time annuity benefits are paid under an annuity contract.
<i>Churning</i>	The inappropriate replacement of contracts.
<i>Deferred Annuities</i>	An annuity contract where money accumulated is designed to provide annuity payments to begin at some future date.
<i>Flexible Premium</i>	A premium that can be varied as to the amount and time of payment at the option of the premium payor.
<i>Guaranteed Minimum Interest Rate</i>	During the contract accumulation phase, it is the minimum interest rate that a company guarantees to credit to the accumulation value of an annuity contract.
<i>Immediate Annuities</i>	An annuity contract that provides a periodic payment to begin soon after purchase.
<i>Joint and Survivor Annuity</i>	A contract that pays annuity benefits to one or more named annuitants until the death of the last surviving named annuitant.
<i>Premium</i>	Purchase payments made to an annuity contract to accrue benefits.
<i>Surrender</i>	The return of an annuity contract to the insurance company for a refund of the accumulation value of the contract less any applicable surrender charges.
<i>Surrender Charge</i>	A deduction made from an annuity contract's accumulation value when the annuity contract is cash surrendered within a stated period.
<i>Variable Annuity</i>	An annuity contract providing for benefits that vary up or down in value depending on the experience of the underlying investments of the annuity contract.

What is an annuity?

An annuity is a contract that provides for the periodic payment of income. An annuity contract is designed to pay benefits while a person is living. In contrast, a life insurance policy is designed to pay benefits when a person dies.

What is an annuity contract?

An annuity contract is either an immediate annuity or a deferred annuity depending on when the annuity payments begin.

Immediate annuities generally are purchased by people of retirement age. These annuity contracts provide a periodic payment beginning soon after purchase. For example, if the annuity payment period is monthly, the first annuity payment will be made one month after issuance of the contract.

Deferred annuities are purchased by people who want to accumulate money during their working years so they can receive periodic payments in the future, or who just want to save money for future use. During the accumulation phase, interest is credited to the accumulated value. No taxes are owed on the credited interest until annuity payments begin.

How is the interest rate determined?

Interest rates on a deferred annuity are determined by the company and depend on the investment results experienced by the company. The interest rates an annuity earns always are subject to a guaranteed minimum set by the company and disclosed in the policy. The typical guaranteed minimum interest rate is three percent. Some contracts provide for a limited time guaranteed interest rate that exceeds the guaranteed minimum interest rate. For example, a limited time guaranteed interest rate of 6 percent may be in effect for the first three years of the contract. After the initial three year period, a new limited time guaranteed interest rate may be set by the company or discontinued altogether. Either way, your contract always will provide for a guaranteed minimum interest rate.

How can you receive the value of your contract?

You always can receive the value of your deferred annuity contract by contacting your agent or company. During the accumulation phase, an annuity contract may be totally surrendered for its accumulation value, including the credited interest. Some contracts also may allow you to surrender a portion of the accumulation value. A surrender charge usually is applied upon total or partial surrender.

Method of Premium Payment

An immediate annuity is purchased with a single premium payment. A deferred annuity may be either a single premium contract, a contract with level fixed premium payments or a contract with flexible premium amounts.

If you purchase a level fixed premium payment contract and become unable to continue premium payments, you will receive reduced annuity benefit payments.

How long do annuity benefits continue?

The length of time during which annuity benefits are paid depends on the settlement option selected. You may select payment for a fixed period of time such as 20 years or for as long as the annuitant is living.

Other settlement options guarantee a certain number of annuity benefits or a certain total dollar amount to a designated person, even if the original annuitant dies. Annuities also may be issued on a joint and survivor basis, which means that annuity benefits will continue as long as any of the named joint annuitants are living.

When you are ready to select a specific settlement option, you will want to consider the available options and the specific needs of you and your family.

Amount of annuity benefit

The amount of an annuity benefit depends upon the annuity settlement option selected. The benefit amount may be fixed or variable. A ***fixed annuity*** provides a guaranteed annuity benefit amount that does not change.

In contrast, a ***variable annuity*** provides a non-guaranteed annuity benefit amount that varies, depending on the gains and losses experienced on investments underlying the contract. The owner of a variable annuity contract has the option of selecting the investments and making periodic changes to the selections. Investments may include stocks, bonds, money market funds and combinations of these. Since variable annuities have an investment component, they must be registered with the Securities and Exchange Commission and may be sold only by individuals licensed to sell securities, as well as annuities.

Tax deferral features of annuities

If all or any portion of an annuity contract is surrendered, there are tax consequences. Premiums paid for an annuity contract are not tax deductible unless the product is purchased under a specific section of the Internal Revenue Code (IRC). Increases in the value of the contract during the accumulation phase (due to interest income or dividends) grow untaxed until the time of surrender or until benefits begin. Once annuity benefits begin, the interest part of each annuity payment will be taxed as ordinary income for federal income tax purposes.

For Pennsylvania state income tax purposes, once annuity benefits begin, no tax is due while the sum of the annuity payments is less than the premiums paid during the accumulation phase of the annuity contract. Once the sum of the annuity payments is greater than the premiums paid during the accumulation phase, all future payments are subject to the Pennsylvania income tax.

You should contact a tax advisor for further tax information. Also, the Internal Revenue Service has several brochures on annuities.

How do I purchase an annuity?

To purchase an annuity, talk to an agent who is licensed to sell annuities in Pennsylvania. Shop around to compare the various annuity products and insurance companies. Look for insurance company rating services in libraries and bookstores. Examples of these services are A.M. Best, Moody's Investors Service and Standard & Poor's. The ratings provided by these services are opinions as to the relative financial strength and performance of insurance companies.

A checklist for buyers at purchase time

If you have decided to purchase an annuity, become informed of all its features and any material and practices used in the sale of the annuity. Contract features that you should be certain you understand include surrender charges, bonuses and equity indexed based interest credits.

Illustrations

A salesperson may present computer printouts showing payouts of an annuity contract in the future. In reviewing the numbers on the illustration, be sure you understand whether the figures are “guaranteed” or “illustrated.”

Guaranteed amounts mean the company must pay the amount shown. Guaranteed amounts are based on conservative assumptions about the company’s future rate of return on its investments. If the company’s assumptions are correct, it must pay at least the guaranteed amount. If the company’s assumptions are wrong, and its investments do not make as much money as anticipated, the company still must pay at the rate that it guaranteed.

Illustrated values are one view of how the contract might perform given certain assumptions about future returns on the investments that support the annuity. Illustrated values are only estimates. The insurance company is not contractually bound to pay illustrative figures.

Assumptions vary greatly among insurance companies. Some companies are aggressive while others are conservative in their illustrations; therefore, you should be careful in comparing illustrations from different companies.

One thing you can count on is that the contract’s actual performance will be different from any illustrations that are not guaranteed. The payout may be higher and it may be lower. Read all the illustrations, especially the explanatory notes. If the illustration refers to explanatory notes, but does not include them, ask that you be given a copy.

Surrender charges

To recoup expenses involved in issuing an annuity contract, most companies apply a surrender charge during the early years whenever a deferred annuity contract is surrendered for its total or partial accumulation value. Typical surrender charges are 10 percent in the first year decreasing to zero after a five to ten year period following issuance of the contract. Some contracts deduct an additional charge equal to a portion of the interest that was credited to the accumulation value prior to surrender.

Contracts frequently provide that applicable surrender charges will not be applied if a surrender is made during a certain window period, such as the last 30 days of each contract year. Surrender charges also may be waived if a specific condition is present, such as when the credited interest rate falls below a certain stated percentage.

Annuity Interest Bonus

Some annuity contracts provide that the company will credit the first premium paid with an amount in addition to the interest rate. For example, an interest rate of 6% plus a bonus of 5% may be credited to the first premium payment. The expense charges of the contract may be increased and could over time exceed the bonus.

Annuity Benefit Bonus

Some annuity contracts provide that the company will increase the amount of the annuity benefit. To receive this increase, the benefit payment period must be a certain number of years as determined by the company. If the contract is surrendered at any time prior to when the annuity benefit payment begins, you would not benefit from the annuity bonus.

Equity Indexed Annuities

Some companies sell equity indexed annuities. Under an equity indexed annuity, the interest credited to the accumulation value is based on the performance of an established stock market index, such as *Standard and Poor's 500*. A formula in the annuity contract is applied to the change in the stock market index over some period of time to determine the interest credits to the accumulation value. The interest credits usually are less than the full amount of change in the stock market index and are subject to both a minimum and maximum. In addition, the company guarantees that the accumulation value will not be less than an amount set forth in the contract.

Churning

Churning is considered to be the improper activity of an agent replacing one policy with another policy issued by the same or different company through misrepresentation of the new or existing policy. Such activity is undertaken repeatedly to generate new business commissions that are substantially higher than renewal commissions. Transactions of this type generally are not in the best interest of the policyholder.

It is not illegal for a salesperson or company to sell new contracts in replacement of existing contracts. It is illegal to use unfair and deceptive sales practices to convince the annuitant to accept a replacement. Churning usually benefits the salesperson, not the consumer.

Be extremely cautious when replacing an annuity contract. Do not change your existing contract unless you are convinced that the new contract is in your best interest.

Changing contracts is costly. In addition to paying a surrender charge when you surrender your existing policy, you also may be charged a sales fee which is

deducted from your initial premium paid under the new contract. Additionally, you may lose a bonus credit under your existing contract.

When alternative products are presented as being “better” because they are new and innovative, or offer better returns, be very cautious. Whenever a salesperson recommends that you replace an existing contract, obtain a written explanation of why doing so would be beneficial for you. Then review this explanation with an independent advisor, such as a certified public accountant, attorney, or financial planner, before you act.

Replacement of an annuity contract may be legitimately in your best interest if you fully understand what you are giving up and what you are purchasing. If you do decide to make a change, never cancel your existing contract until your new contract is in place.

What to look for in an agent

An agent should be willing to listen to you and look for ways to find the right type of annuity for you. At the time of purchase, after you have read and are sure you understand everything you are signing, **make your check payable to the insurance company**, not to the agent. Be sure the agent gives you a receipt.

Never pay cash. This will reduce the possibility that the salesperson could mishandle your funds.

Free look period

If you buy an annuity contract and are not satisfied with the contract for any reason, you may return it directly to the agent or company within ten days after receipt of the contract for a full return of the premium paid. Your annuity contract will provide for longer than ten days if your new contract replaces an existing contract. In the case of a variable annuity, your contract may provide for an amount other than a return of the premium paid.

As a safeguard, you are encouraged to use certified mail to establish the date the contract was mailed back to the agent or company.

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