Electronically Submitted to NASAAComments@nasaa.org

December 3, 2023

North American Securities Administrators Association, Inc. (NASAA)

Attn: Amy Kopleton, Group Chair, Broker-Dealer Market and Regulatory Policy and Review Project, Stephen Bouchard, Former Chair, Broker-Dealer Section, James Nix, Chair, Broker-Dealer Section
750 First Street, N.E., Suite 990
Washington, D.C. 20002

Re: Proposed Revisions to NASAA's Dishonest or Unethical Business Practices of Broker-Dealers and Agents Model Rule

On behalf of our members, the Insured Retirement Institute (IRI)[1] writes to provide comments on the proposed revisions to NASAA's Dishonest or Unethical Business Practices of Broker-Dealers and Agents Model Rule (the "Proposal"). Our members have strong concerns with the Proposal and its impact on the retirement income industry and the annuity marketplace. The Proposal directly conflicts with and deviates substantially from the U.S. Securities and Exchange Commission's Regulation Best Interest ("Reg BI") and essentially creates a new standard on top of the existing regulatory landscape. As such, the Proposal will decrease uniformity, is confusing and unnecessary, and raises significant issues of preemption under federal law. For these reasons, and as outlined below, we strongly urge NASAA to withdraw the proposal. If NASAA does not withdraw the Proposal, as an alternative, it should be revised to eliminate every revision other than that which is a pure incorporation of Reg BI.

<u>The Proposal will have significant negative implications for the retirement income industry and the annuity marketplace.</u>

Financial services companies and insurers who offer solutions to help Americans save more for retirement, and create sustainable, lifetime income from their savings, are critical to helping

[1] The Insured Retirement Institute (IRI) is the leading association for the entire supply chain of insured retirement strategies, including life insurers, asset managers, and distributors such as broker-dealers, banks and marketing organizations. IRI members account for more than 95 percent of annuity assets in the U.S., include the top 10 distributors of annuities ranked by assets under management, and are represented by financial professionals serving millions of Americans. IRI champions retirement security for all through leadership in advocacy, awareness, research, and the advancement of digital solutions within a collaborative industry community.

Americans manage their needs and risks. The need for insured retirement products and solutions is arguably greater than ever as Americans are living longer, health care costs continue to increase, and fewer Americans are covered by traditional pension plans and the age to receive full Social Security benefits has increased. Annuities, and specifically variable annuities, are one example of an important product that can help provide Americans with protection during their retirement by providing a guaranteed stream of income during retirement. Annuities can provide many benefits to consumers, both by having more built-in protections and the opportunity to add riders that can meet particular needs. It is crucial that consumers have access to these products, which are sold under the appropriate standard of conduct, so that they can achieve their financial goals and have a dignified retirement.

Each year, IRI publishes a Retirement Fact Book[2], which is a guide to concepts, solutions, trends, and data in the retirement income industry. The Fact Book provides detailed information on the features of annuities, illustrating the wide variety of benefits that a consumer could obtain from an annuity, and is known as a reliable source in the industry for annuity information and retirement topics. Chapter 4 of the Fact Book is a primer on annuity products, which is attached as Appendix A to this letter. We respectfully encourage NASAA and its members to review the Fact Book, and Chapter 4 in particular. For those who may have had less exposure to annuities, this chapter would provide a solid foundation for regulators to better understand annuity products, including how they work, how they are sold, and how they differ from non-insurance securities products. We also believe reviewing this chapter would be valuable for those with more experience in the annuity space as a refresher on some of the important nuances and details. We would be happy to meet with anyone from NASAA or any of its members to answer any questions you may have or to provide any additional information you may need about the annuity sector.

IRI members have serious concerns about creating a new standard that goes well beyond, and conflicts with, Reg BI and the enhancements to the Suitability in Annuity Transactions Model Regulation[3] approved by the National Association of Insurance Commissioners ("NAIC") in early

[2] IRI's Retirement Fact Book (https://www.irionline.org/wp-content/uploads/2023/09/Research-2023-IRI-Fact-Book.pdf) (2023)

[3] While the official name of the NAIC Model refers to a suitability standard, the 2020 version replaced the suitability standard imposed under prior versions with a best interest standard that aligns with the standard established under Reg BI. The NAIC intentionally decided not to change the official name of the NAIC Model in order to avoid any uncertainty with respect to the requirements of Section 989J of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). Under Section 989J of the Dodd-Frank Act, certain annuities are treated as exempt from the Securities Act of 1933 if, among other things, the NAIC Model (or a successor regulation that meets or exceeds the requirements of the version that was in effect when the Dodd-Frank Act was enacted by Congress) has been adopted by the state in which the annuity is issued or by the state of domicile of the insurance company that issues the annuity.

2020 ("NAIC Model"). The revised NAIC Model is consistent with the heightened standards of conduct imposed by Reg BI.[4] The objectives are aligned, and the NAIC Model essentially brought Reg BI over to the insurance side (while creating a safe harbor for firms and agents that were complying with Reg BI). The NAIC spent many years on a robust process that considered feedback from multiple stakeholders while working through various issues. The NAIC was clearly committed to a transparent, inclusive process when working through these amendments. As a result, very clear policy decisions were made about what the standard should be, and 40 states have adopted the NAIC Model thus far.

Adding a contradictory model to the annuity regulatory landscape, such as the Proposal, is inconsistent and problematic. This presents a complex regulatory issue since a state insurance regulator who asserts jurisdiction over variable annuities will rely on the NAIC Model, while the state securities regulator will rely on a different set of rules for the same security. Additionally, this line is further blurred by the fact that variable annuities in some states are regulated only as insurance products and in others as both insurance and securities. This creates a significant conflict and would subject firms to competing jurisdictional issues.

In addition to this issue, several of the provisions in the second set of revisions ("Revision Set #2") would be very problematic if applied to variable annuities. More detail on our concerns with each specific proposed provision is outlined below, but a few key issues are:

- The requirement that reasonably available alternatives must be considered (Subpart 1d(3)(b)) without any clear limitations on what this includes and how this applies for agents also appointed to sell insurance.
- The Conflicts of Interest provision (Subpart 1d(2)), which creates a presumption that a broker-dealer or agent has placed its financial interest ahead of the consumer when any additional compensation is earned or received beyond commissions.
- The definition of "recommendation" (Subpart 1(d)(5)) is extremely broad and would impact advertisements, marketing materials, social media communications and more.

If adopted, these provisions, among others, would have a significant impact on how products are structured and the relationship between an insurer and a broker-dealer. This could lead broker-dealers to significantly alter their business model by limiting or removing annuities from their list of offerings. The Proposal could also drive firms to stop offering brokerage services, which would

---

[4] Similar to Reg BI, the revised NAIC Model requires insurance producers to act in the best interest of the consumer under the circumstances known at the time a recommendation is made, without placing the producer's or the insurer's financial interest ahead of the consumer's interest. In addition to the enhancements to the applicable standard of conduct and supervisory requirements, the revised model also reflects important adjustments to the training provisions and the FINRA safe harbor included in the prior version of the model.

leave many consumers without access to professional support if they do not have enough assets to qualify for a fee-based account. Overall, the Proposal could result in a dramatic shift in the marketplace and subsequent loss of access or limitation of products for consumers.

It is unclear how the NAIC Model and Reg BI together are not adequately protecting consumers seeking to purchase variable annuities where it would be deemed necessary to add another layer of rules. The commentary in the notice for Request For Public Comment ("Notice") provides no evidence to the contrary. This Proposal would unjustifiably result in impeding access to these important products for consumers that need them.

We think it is important to note, however, that we do not oppose a revision that is a pure incorporation of Reg BI. We do not oppose NASAA moving forward with Revision #1, and we think NASAA could and should have stopped there. The appropriate course of action would be for states to incorporate Reg BI and then through their enforcement authority, address practices that are not in compliance with Reg BI. We fully support state securities regulators' enforcement efforts to address bad actors, and such efforts should be a top priority, as opposed to confusing, unnecessary rulemaking. In fact, state securities regulators already can enforce compliance with Reg BI, and there should not be more to do beyond incorporating the principles of Reg BI. It's unclear why expanded revisions that go well beyond the current requirements are needed to ensure compliance and enforcement of Reg BI.

The Notice, however, indicates that Revision Set #2 is needed because firms have not made certain changes in response to Reg BI. We believe this premise to be flawed. The recent Report and Findings of NASAA's Broker-Dealer Section Committee: National Examination Initiative Phase II (B) ("Phase II (B) Report") acknowledges the "helpful and steady implementation progress that has been made" and frequently acknowledges that "overall, most of the firms examined/or generally firms" were taking some form of appropriate steps or action. While the Phase II (B) Report did highlight areas where certain broker-dealers and agents seemingly fell short of full compliance with Reg BI, it's notable that it did not find that investors were not effectively protected when a broker-dealer was in full compliance with Reg BI. As such, it's unclear how the Phase II (B) Report justifies additional rulemaking.

Broker-dealers made numerous changes to their policies and procedures, supervisory and account opening systems, training, and testing in order to comply with Reg BI in 2020.[5] . Overall, broker-dealers have evaluated and enhanced their compliance policies and procedures on an ongoing basis. For example, broker-dealers have simplified their product shelves, modified compensation structures (including levelizing compensation for certain products), and implemented and enhanced new disclosure/documentation requirements. Broker-dealers have

---

[5] Many broker-dealers have also made significant changes to their policies and procedures to comply with the U.S. Department of Labor's Prohibited Transaction Exemption 2020-02.

also built out compliance structures for better analyzing reasonably available alternatives, including the implementation of more tools to conduct this analysis and to supervise financial professionals.

It is crucial that new rules have time to work and that enforcement actions are appropriately able to address bad actors. Reg BI has only been in effect for 3.5 years, and this was a major overhaul of the previous decades-long suitability standard. Rather than adding additional layers of complex and confusing requirements, conflicting interpretations, and variations in standards of conduct, rules need to be given time to work.

The "menu of provisions" as presented in the Proposal will decrease uniformity, will contribute to a patchwork of state securities regulations, and will raise significant issues of federal preemption.

We believe the provisions in Revision Set #2 would likely be preempted by the National Securities Markets Improvement Act of 1996 ("NSMIA") if challenged in federal court. The goal of NSMIA was to prevent the imposition of a patchwork of state regulation on top of extensive securities laws and rules already in place with which investment advisers, broker-dealers, and securities agents ("firms and agents") must comply. NSMIA expressly preempts states from establishing regulations requiring firms and agents to make and keep records that differ from or are in addition to the requirements established under federal rules.[6] Despite NASAA's attempt to address this by including a Savings Clause in Subpart 1(d)(8), Revision Set #2 deviates substantially from and conflicts with Reg BI in numerous ways, as outlined below. As such, extensive record-keeping and documentation would be necessary to demonstrate compliance with the requirements that differ from and add to federal regulation. This is precisely what NSMIA is intended to avoid. If adopted as drafted, we believe the amendments in Revision Set #2 would face significant legal challenges on the grounds that they are preempted by federal law. It is unclear how model rule amendments that may ultimately open the door to litigation in any adopting states serve NASAA's stated goals of ensuring financial market integrity and investor protection.

Additionally, the availability of eight different subparts within Revision Set #2 could result in numerous variations depending on which subparts a state chooses to adopt. NASAA's claims that this menu of options will somehow promote uniformity are very concerning when in fact it would clearly have the opposite effect. This will inevitably create a patchwork of requirements that are inconsistent with Reg BI, ultimately resulting in confusion about how firms and agents can and should comply with the rule.

---

[6] 15 U.S.C. § 78o(i)(1)

<u>While the Proposal claims to simply incorporate SEC guidance, it goes well beyond and contradicts the requirements of Reg BI and SEC staff guidance.</u>

First, the commentary in the Notice claims that the Proposal "was written to align with the principles of Reg BI and incorporate SEC's related interpretative guidance." As explained above, we disagree with the premise that Revision Set #2 aligns with Reg BI. Moreover, we disagree with the assertion that the Proposal simply incorporates SEC Staff guidance and with the very premise that incorporating SEC guidance is appropriate. The SEC Staff guidance was never intended to be treated as operative regulatory text. The SEC has made clear that "the staff bulletin, like all staff statements, has no legal force or effect: It does not alter or amend applicable law, and it creates no new or additional obligations for any person."[7] Perhaps even more important, the Proposal actually would incorporate NASAA's *interpretation* of this SEC staff guidance, creating a significant risk of confusion and inconsistency between the federal and state rules. In effect, this Proposal then becomes a "back door" amendment to Reg BI at the state level.

As indicated above, we'd like to reiterate three major areas where the Proposal deviates from and conflict with Reg BI:

1) **Subpart 1d)(2): Conflicts of Interest:** The subpart directly conflicts with and goes beyond the requirements of Reg BI in such a way that compliance would be extremely difficult, if not unworkable, and this would impact the way the industry works to its detriment and that of consumers who would lose access to important financial products.

   Firstly, the Proposal's requirement that "a broker-dealer or agent must make all reasonable efforts to avoid or eliminate conflicts of interest…[and those] that cannot reasonably be avoided or eliminated must be disclosed and mitigated" is not the same as in Reg BI.[8] A broker-dealer is not required under Reg BI to "make reasonable efforts to avoid or eliminate" conflicts of interest related to a recommendation. Only certain conflicts of interest must be eliminated under Reg BI, namely sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sales of specific securities within a limited period of time.[9]

[7] See Footnote 1 to Staff Bulletin: Standards of Conduct for Broker Dealers and Investment Advisers Account Recommendations for Retail Investors (https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers)).

[8] 84 FR 33387 (https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf) (requires "policies and procedures that are reasonably designed to identify and at a minimum disclose (pursuant to the Disclosure Obligation), or eliminate, all conflicts of interest associated with the recommendation; and (2) adopt specific requirements with respect to such policies and procedures for the mitigation and elimination of identified conflicts of interest.")

[9] 84 FR 33387 (https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf)

Taken literally, any conflict of interest can be reasonably "avoided" or "eliminated" by simply refraining from engaging in the activity that gives rise to the conflict. This is clearly not always the most appropriate means of handling conflicts. By taking this extreme approach, the Proposal seems to reflect a predetermination that conflicts can never be effectively managed or mitigated. In addition, the Proposal provides no clarity as to the steps a firm or agent would be reasonably expected to take to "avoid or eliminate" a conflict. Regulatory uncertainty (and second guessing) is problematic for broker-dealers seeking to comply with the requirements, and rather than risk enforcement action, broker-dealers may simply choose to eliminate products and services. The Proposal could drive firms to stop offering brokerage services, which would leave many consumers without access to professional support if they do not have enough assets to qualify for a fee-based account. Overall, consumers will be left with fewer choices among brokerage products or services and potentially without access altogether.

While it's unclear when it would ever be acceptable to mitigate a conflict of interest, there's no guidance as to how a broker-dealer would go about doing this. The Proposal states "mitigating a conflict of interest means neutralizing or reducing the potential for harm or adverse impact of the conflict to the retail customer", but this is different from SEC guidance on mitigation, and it's unclear what it would mean to "neutralize" the conflict and how that would be satisfied.

Another concerning item in this subpart is the presumption language relating to "sales contests" that goes beyond Reg BI. The Proposal adds an additional phrase that states "where the broker dealer…rewards the broker-dealer or agent with additional cash or non-cash compensation beyond the sales commission as the result of that recommendation." This calls into question <u>any</u> compensation earned or received by a broker-dealer or agent beyond commissions and would effectively prohibit broad categories of variable compensation programs, such as benefits and recruitment agreements/incentives, which are otherwise structured to comply with Reg BI. There then would be a rebuttable presumption that the receipt of any compensation beyond basic sales commissions results in the broker-dealer or agent engaging in a dishonest and unethical practice. This creates compliance uncertainty about what would need to be done to "rebut" the presumption, and this could lead to wholesale changes in industry practices to the detriment of the consumer. This directly conflicts with Reg BI's overall compensation framework, which is designed to, and in fact does, promote retail investors' access to products, services and best interest investment advice.

2) **Subpart 1d(3): Care, Skill, and Diligence:** Under this subpart, a broker-dealer or agent is required to "make reasonable inquiry regarding lower-cost and lower-risk securities and investment strategies that are reasonably available to the broker-dealer or agent, as well

as products or services available if the agent is also [licensed/registered] in other capacities such as an investment adviser representative or insurance agent." This conflicts with SEC guidance that a broker-dealer does not have to consider alternatives that it does not offer on its product platform. The SEC made clear that "a broker-dealer does not have to conduct an evaluation of every possible alternative, either offered outside of the firm (such as where the firm offers only proprietary products or other limited range of products) or available on the firm's platform"[10] and that "cost is one important factor among many factors."[11] The Proposal seems to take a contradictory approach by implying that a broker-dealer would need to consider alternatives not on its platform simply because they are "lower cost" or "lower risk."

This language in this subpart is also concerning for what it means for agents licensed in "other capacities." For agents licensed to sell securities who are also appointed as insurance agents, it's unclear as to how this language impacts recommendations regarding insurance products, whether variable or fixed. There's no clarity as to what this language is intended to cover in terms of alternatives to be offered in the annuity context for such dually-registered persons. This presents a significant question as to how an agent would comply with this provision.

3) **Subpart 1d(5) Recommendations:** The Proposal's redefinition of recommendation directly conflicts with Reg BI and has extremely broad ramifications. The introduction of the phrase "any means, method or mechanism to feature or promote an account type, specific security or investment strategy to a retail customer, whether directly or through a third party" would impact advertisements, marketing materials, social media communication and more. Additionally, any digital engagement practices are essentially recommendations under this definition. Many marketing brochures and client-facing documents are intended to educate clients about specific products or strategies, and the SEC has made clear that there is a distinction between "education" and "recommendation." However, under this Proposal, this distinction no longer appears to exist. The phrases "any means, method or mechanism" that "feature or promote" seems to cover every possible form of communication with a consumer when it involves a broker-dealer's products.

   The impact on a firm's supervisory systems and procedures would be significant, as it's unclear how a firm would even reasonably design a system to supervise under this new redefinition. The sheer breadth of the phrase "any means, method or mechanism" sweeps in well-understood practices and activities that do not involve a "recommendation" (e.g., research reports pulled down from a firm website by a client,

---

[10] 84 FR 33381 (https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf)

[11] 84 FR 33372 (https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf)

FINRA's mutual funds analyzer tool, retirement tools). This could cause significant disruption within the industry, particularly for self-directed brokerage, given that firms would have to alter their business model and/or stop offering certain products due to this unworkable provision. A self-directed brokerage firm would have to design a supervisory system to identify when a "recommendation" is being made, which is directly contrary to the existing business model (and one based on well-understood SEC and FINRA guidance[12]).

In addition to these concerns outlined above, this Proposal includes a number of other problematic and unworkable provisions that go well beyond and conflict with Reg BI:

1) **Subpart 1d(1): Compliance and Disclosure:** This language conflicts with the SEC Adopting Release's section discussing the Conflicts Obligation and in particular the SEC guidance therein regarding mitigation of firm-level financial incentives. The SEC has made clear that firm-level conflict can generally be addressed through disclosure.[13] This also implicates NSMIA preemption as additional documentation/recordkeeping would be needed to demonstrate compliance.
2) **Subpart 1d(3): Care, Skill, and Diligence:** This subpart appears to add a different standard than Reg BI, with its inclusion of the language "a like capacity and familiar with such matters." It also adds "education," "debt," and "any other relevant information" to the list of relevant facts and circumstances to be considered, thereby going beyond what is required under Reg BI, without any reasoning as to why the list should be expanded. "Any other relevant information" also is vague, unlimited, and unworkable in terms of what information should be considered.
3) **Subpart 1d(4): Costs:** This subpart expands the potential fees and costs that broker-dealers and agents are required to "take into consideration" and again goes beyond the requirements of Reg BI. Of particular concern is the new requirement that the "sum total of all potential fees and costs based on the anticipated holding period for the security." This, on top of the laundry list of costs within this subpart, is virtually impossible for a broker-dealer or agent to take into consideration and provide a disclosure on costs for every recommendation. Factoring costs over a holding period is not a requirement in Reg BI, and there is no guidance as to how an anticipated holding period and any potential costs would be evaluated. This would likely result in broker-dealers changing their business model and reducing the number and types of securities it offers, and therefore resulting in fewer product choices for consumers.

---

[12] See e.g, NASD NTM 01-23 (https://www.finra.org/rules-guidance/notices/01-23)

[13] 84 FR 33390 (https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12164.pdf) ("rather than requiring mitigation of all firm-level financial incentives, we have determined to refine our approach by generally allowing firm-level conflicts to be generally addressed through disclosure.")

4) **Subpart 1(d)(6): Retail Customer:** This subpart also creates a new definition that conflicts with and expands beyond Reg BI. Reg BI only applies to recommendations that are used primarily for *personal, family, or household purposes*, but the Proposal's definition does not include this definition. The commentary in the Notice claims that this subpart provides additional clarity, but it's unclear how two different definitions of retail customer will provide any certainty as to whom the term applies to. Of specific concern to our members is how this would apply to employee benefit plan sponsor interactions. It appears, based on the proposed definition, that unless a plan sponsor qualifies as an "institutional buyer" under that state's law, they would be considered a "retail customer" under the definition. As stated earlier, plan sponsors are not considered retail customers under Reg BI so that should remain consistent in state securities law.
5) **Subpart 1(d)(8): Savings Clause:** As mentioned above, we do not believe this clause would effectively overcome NSMIA preemption. As we understand it, the test for preemption under NSMIA is a functional test, meaning a state regulation could be preempted if it effectively requires the creation of new records beyond those required under federal law even if the regulation purports to disclaim the imposition of any such requirement. Given the multiple differences between the Proposal and Reg BI, firms will inevitably be required to create new records in order to demonstrate compliance under Revisions Set #2. Despite the Proposal's attempt to avoid implicating NSMIA preemption issues by inserting this subpart, there is no doubt that additional record-keeping and documentation will be essential for firms to comply with the new and distinct requirements of Revisions Set #2.

In summary, our members have significant concerns as to the Proposal's impact on the variable annuity and insured retirement industry. Revisions Set #2 goes well beyond and directly conflicts with Reg BI and would decrease uniformity, contribute to a patchwork of requirements across the states, and also raises significant issues of preemption. For these reasons, and as outlined above, we urge NASAA to withdraw the proposal.

Thank you for your consideration of these comments, and please do not hesitate to reach out with questions or if additional information is needed.

Sincerely,

Sarah E. Wood

Sarah Wood
Director, State Policy & Regulatory Affairs
Insured Retirement Institute
swood@irionline.org

Annuities 101

What Is an Annuity?

Annuities have been around for centuries. In early Roman times, citizens would make a one-time payment to a contract known as an *annua* in exchange for income payments received once a year for the rest of their lives. Today, an annuity is an insurance agreement that comes in a number of different forms and can (1) help individuals accumulate money for retirement through tax-deferred savings, (2) provide them with monthly income that can be guaranteed to last for as long as they live, or (3) do both.

An annuity can be viewed as life insurance in reverse. Whereas life insurance protects a family's financial situation against the premature death of a breadwinner, an annuity protects an individual or a couple from running out of money at an advanced age. As with life insurance, annuity contracts are based on the principle of risk pooling; that is, the pooled funds of a large group are used to pay benefits to a relative few in any given year. The burden of not knowing how long one will live is shifted from the individual to the insurance company, which spreads the longevity risk among all annuitants, some of whom will die sooner than expected while others will live longer than expected. A good analogy is homeowner's insurance: the risk of fire is common to all homeowners, but during a given span of time only a few houses will burn down. For most people such an event would be financially devastating, so the risk is pooled using insurance.

Annuities can play a vital role in helping investors save for retirement and receive guaranteed lifetime income during retirement — effectively giving them the ability to create their own pensions. Unlike other investments, annuities provide a wide variety of benefit options that can protect against untimely death, provide principal guarantees, assure a specified amount of income when the contract is annuitized, guarantee withdrawals for life, or a combination of all of these.

What Role Can Annuities Play in a Comprehensive Retirement Plan?

Annuities are the only financial instruments available today, other than Social Security and employer-provided pensions, that can guarantee a lifetime stream of income during retirement. Along with giving retirees the peace of mind that comes from knowing they will not outlive their assets; annuities provide another important benefit — a way to increase current income.

Many of today's retirees are faced with the challenge of how to withdraw enough money from their portfolios to live comfortably during retirement without depleting their funds if they live a long life. Withdrawing money from an investment portfolio may not present a problem in the early years, but as retirees age, the risk of running out of money can increase dramatically. Allocating a portion of the portfolio to one or more annuities reduces this risk.

Annuity payments form an essential part of a comprehensive retirement plan along with Social Security and pension income. The amount of each annuity payment reflects the fact that some annuitants will not live as long as others. This "risk pooling" allows insurance companies to make annuity payments that are larger than would be possible through a systematic withdrawal plan, where an individual retiree periodically withdraws funds in amounts that give reasonable assurance that he or she will not run out of money. Thus, annuities can serve to both reduce the risk of running out of money in retirement and increase the amount of each income payment received.

Who Are the Parties to an Annuity Contract?

Most annuity contracts — and all commercial annuity contracts — are issued by life insurance companies. When the purchaser completes the application to buy an annuity, the contract owner, annuitant, and beneficiary are designated and identified as such in the contract.

Contract Owner

The owner of an annuity contract pays the premiums. He or she has certain rights under the contract, such as the right to make contributions, withdraw all or a portion of the contract value, or change the parties to the contract. The owner is usually an individual or couple but can also be a non-natural person such as a trust or a partnership. Special tax rules apply to annuities owned by non-natural persons.

Annuitant

The annuitant is the person upon whose life annuity payments are based. Often, the annuitant is also the contract owner, so payments continue as long as the owner/annuitant is alive. It is also possible for two people, such as an owner and spouse, to be designated as joint annuitants so that income can continue throughout either of their lives. This type of annuity is called a "joint and survivor annuity." While in most cases payments are made to the contract owner or annuitant, funds also can be paid to a third party referred to as a "payee."

Beneficiary

The beneficiary is the person designated under the contract to receive any payments that may be due upon the death of the contract owner or annuitant. Contingent beneficiaries, to whom payments are made in the event the primary beneficiary predeceases the owner or annuitant, may also be named in the contract.

Respective Rights of the Parties

Because annuity contracts can offer a great deal of flexibility in setting up income payments, the respective rights of the contract owner, annuitant, and beneficiary can vary. For example, under one insurer's contract, the owner may be entitled to receive annuity payments. Under another insurer's contract, the annuitant may be the party entitled to receive annuity payments.

What Types of Annuities Are Available?

A wide variety of annuities are available today, many designed to meet specific needs and help consumers achieve their retirement goals. With a deferred annuity, assets accumulate on a tax-deferred basis until distributions are made, usually during retirement; with an immediate annuity, the contract owner converts assets into income and starts receiving payments right away. Fixed annuities accumulate savings or distribute income at guaranteed rates and in guaranteed amounts; variable annuities accumulate savings or distribute income based on the performance of the underlying investment options chosen by the contract owner. Annuities can be part of an IRA, a qualified retirement plan such as a 401(k) or 403(b) (a "qualified" annuity) or may be purchased with after-tax dollars (a "non-qualified" annuity). The following is a more detailed look at various types of annuities.

Figure 4-1 Types of Annuities

	Deferred	Immediate
Variable (VA)	• Purchased either with a single premium or with periodic payments to help save for retirement; the contract owner determines the point at which accumulated principal and earnings are converted into a stream of income. • The contract value or income payments vary based on the investment performance of underlying subaccounts or a stated rate, if provided by the issuer. • Total sales of deferred VAs in 2022 were $98.6 billion.	• Purchased with a single lump sum; income payments begin within a short period — less than 13 months. • The income payments vary based on the investment performance of underlying subaccounts or a stated rate, if provided by the issuer. • Total sales of immediate VAs in 2022 were about $0.1 billion.
Structured	• Structured annuities, also called Registered Index Linked Annuities (RILAs) use options on market indexes to provide purchases with upside potential and downside protection • RILAs carry investment risk, and are therefore a form of variable annuity • Total RILA sales in 2022 were $36.4 billion (included in deferred VA total sales above)	• There are no immediate versions of RILAs, but as a variable annuity they may be annuitized to create a fixed lifetime income stream
Fixed	• Purchased either with a single premium or with periodic payments to help save for retirement; the contract owner determines the point at which accumulated principal and earnings are converted into a stream of income. • Guarantees that the contract owner will earn a stated rate of interest during the accumulation phase of a deferred annuity and receive a defined amount of income on a regular schedule when the contract is annuitized. • Total sales of deferred fixed annuities in 2022 were $192.2 billion.	• Purchased with a single lump sum; income payments begin within a short period — less than 13 months. • The income payments are a pre-determined amount on a regular schedule. • Total sales of immediate fixed annuities in 2022 were $10.3 billion. • Total sales of deferred income annuities (essentially “immediate” annuities with a five to 40 years waiting period before payments begin) in 2022 were $1.0 billion.

Source: Morningstar, Inc.; Beacon Research

What Are the Differences Between Deferred and Immediate Annuities?

Deferred Annuities: A Way to Save Money for Retirement

Many people buy annuities because they want their money to grow tax-deferred while they are saving for retirement, and they want a guaranteed income stream once they retire. This type of annuity is called a deferred annuity. A deferred annuity contract has two phases — an accumulation or savings phase, and a payout or retirement income phase.

In the accumulation phase, the owner pays premiums (also referred to as purchase payments) into the contract to accumulate assets. Some contracts are purchased with a single payment and are called single premium contracts. Other contracts allow payments to be made at any time and are called flexible premium contracts. During the accumulation phase, the owner can surrender the contract or take one or more partial withdrawals.

In the payout phase, the owner (or other designated payee) receives income. When he or she wants payments to begin, the insurance company starts sending checks on a regular basis, typically monthly. The effective date of payments is called the annuity start date or the annuity commencement date. In certain circumstances, the insurance company will allow annuity payments to be commuted for a lump sum equal to their present value.

Immediate Annuities: When You Want to Receive Money Right Away

An immediate annuity (commonly known by the acronym SPIA, which stands for Single Premium Immediate Annuity, and may also be called a "payout" or "income" annuity) is purchased with a single premium and annuity payments begin right away (there is no accumulation period). If the owner chooses to receive monthly payments, payments usually begin at the end of the first month but may be scheduled to start any time within one year after purchase. An immediate annuity can be purchased using retirement savings, for example, from a 401(k) plan and/or personal savings, as a way to create guaranteed income payments during retirement. It can also be purchased using money from other sources, such as an inheritance or the sale of a business.

Annuity payments can be made over the lives of one or more individuals or for a specified number of years, e.g., for 10 or 15 years. Life annuity payments typically end when the annuitant dies, but various types of guarantees are widely available. For example, you can purchase a life annuity with 10 years of payments guaranteed. Under such an annuity, the payments will continue for the longer of 10 years or the annuitant's life. In addition, insurers offer annuity payments that provide that if the annuitant dies before annuity payments equal to the premiums paid for the contract have been paid, the contract beneficiary will receive a lump sum equal to the difference between the sum of the annuity payments and the premiums paid ("cash refund"). As there are many payout options offered by issuing insurers, the owner should work with his or her financial advisor to assure that the payment feature meets his or her financial needs.

Data from the CANNEX annuity quoting platform shows about one-third of quote requests, a good proxy for sales, are for SPIA with cash refund, about 20 percent are for life-only payments, and the remaining approximately one-half are for life with periods certain of various durations, 10 years being the most common. More than 85 percent are for monthly payments.

Inflation-Protected Annuities

An inflation-protected annuity (IPA) is similar to an immediate annuity but payments are indexed to the rate of inflation. Initial payments will usually be smaller than they would be without the

inflation protection. Even at a moderate rate of 4 percent, inflation reduces the purchasing power of one dollar to fifty cents in approximately 15 years. IPAs guarantee a real rate of return at or above inflation. Very few life insurance companies offer true IPAs for sale in the United States (largely due to the difficulty of hedging the inflation risk). However, consumers can buy immediate annuity contracts available that provide pre-determined annual increases in the amount of annuity payments, e.g., 3 percent each year for the life of the contract. CANNEX data indicates more than 90 percent of quotes include no payment adjustment feature, i.e., no provision for increasing future monthly payments.

Structured Settlement Annuities

Structured settlement annuities are used to provide periodic payments to satisfy legal judgments. Structured settlement sales numbers are not included in the market data used in this publication.

What Are the Differences Between Fixed and Variable Annuities?

Fixed Annuities: Guaranteed Investment Performance

With a fixed annuity, the owner is guaranteed at least a minimum rate of investment return. The insurer declares a specific credited rate of return based on the investment performance of its general account assets. In the case of a deferred fixed annuity, the insurance company guarantees a minimum interest rate (also known as a minimum credited interest rate) on payments made by the owner during the accumulation phase. In many cases, an insurer will credit interest at a higher rate than the minimum for varying periods. This type of interest is often referred to as "excess interest." The owner's purchase payments are invested in the insurance company's general account. When the annuity reaches the payout phase, the dollar amount of the annuity income payments is determined based on payment rates guaranteed at the time the deferred annuity was issued (or the insurer's current payment rates, if higher) and are guaranteed for the selected payout duration, e.g., the owner's life or a specified period of years.

Generally, fixed annuities involve less investment risk than variable annuities because they offer a guaranteed minimum rate of interest. The minimum rate is not affected by fluctuations in market interest rates or the company's yearly profits. Some people like the security of knowing that their annuity payments will never vary or that they will receive at least a minimum amount of credited interest. Although they are less risky, fixed annuities generally offer less investment flexibility and less opportunity for growth than variable annuities.

Fixed Indexed Annuities: Market-Linked Interest Potential and Guaranteed Minimum Interest

A Fixed Indexed Annuity is a fixed annuity that typically provides the contract owner with an investment return that is a function of the change in the level of an index, such as the S&P 500, while guaranteeing no less than a stated fixed return on the investment. These products are designed for investors who want to partake in the benefits of a market-linked vehicle with a protected investment floor if there is a downturn in the benchmark index. Some indexed annuities also offer riders that guarantee income for life, even if the annuity value declines to zero.

Variable Annuities: Investment Performance Based on Portfolios Chosen by the Owner

With a variable annuity, contract owners may choose from a wide range of investment options called subaccounts, each of which generally invests in shares of a single underlying mutual

fund or, in some cases, in a "fund of funds (FOF)," which is a mutual fund that invests in several other mutual funds or in exchange-traded funds (ETFs). Variable annuity contract owners may direct the allocation of their contract value among subaccounts that correspond to a wide range of underlying mutual funds, such as equity funds, bond funds, funds that combine equities and bonds, actively managed funds, index funds, domestic funds, and international funds. Unlike mutual funds sold to the public, the mutual funds that underlie subaccounts are available only to investors in variable annuities, variable life insurance contracts, and in some cases, 401(k) plans, IRAs, and certain other investments permitted by applicable tax laws and regulations. Assets in a variable annuity can be transferred between subaccounts tax-free. As a result, investment decisions can be made based on an investor's needs and strategy without worrying about the tax implications.

As with mutual funds, the investment returns of variable annuity subaccounts fluctuate. During the accumulation phase, the contract value varies based on the performance of the underlying subaccounts. During the payout phase of a deferred variable annuity (and throughout the entire life of an immediate variable annuity), the dollar amount of the annuity payments may also fluctuate if variable annuitization is chosen, again based on how the portfolio performs. Fixed annuitization generally produces equal payments over the time period selected (life only or life in combination with a minimum payment period).

Unlike mutual funds, annuities offer a wide variety of guarantees to protect a contract owner's investment. Death benefits provide principal protection in the event a contract owner dies during a market downturn. Living benefit features protect against investment and/or longevity risk by providing guarantees that cover income, accumulation, and withdrawals for either a fixed number of years or for life.

In addition to variable investment options or subaccounts, many variable annuities offer a fixed account or fixed investment option. This means that during the accumulation phase of a deferred variable annuity, the owner can allocate payments not only to one or more variable investment options, but to a fixed interest option as well. The money allocated to the fixed option goes into the insurance company's general account. A minimum rate of interest is typically guaranteed for a period of one or more years.

Registered Index Linked Annuities (RILAs) are a relatively recent innovation. RILAs generally do not offer subaccounts (although some include a money market subaccount); rather, purchase payments are invested in the insurer's general account, and a portion is used to purchase options on one or more market indexes selected by the purchaser. The use of options provides some upside potential to contract owners in years when the index(es) perform well, and limit downside risk during years when returns are negative.

During the payout phase of some contracts, only fixed annuity income payments are offered. Other contracts provide fixed and/or variable payouts. Providing both types of payouts allows contract owners to take on the added risk associated with variable investment options while accumulating assets, and to manage their level of risk during retirement by choosing to have the rate of return guaranteed for at least some portion of their income payments.

What Are the Differences Between Qualified and Non-Qualified Annuities?

Qualified Plans versus Non-Qualified Plans

Annuities can be used in tax-qualified retirement plans, such as IRAs, pension or profit sharing plans, 401(k) plans, 403(b) plans, and certain governmental plans. These annuities are called qualified annuities and are typically funded with pretax dollars. (Some qualified annuities are purchased with after-tax dollars for use with Roth accounts, under which the annuity payments and other withdrawals are tax-free if certain tax rules are satisfied.) Annuities that are not used in qualified plans are called non-qualified annuities and are purchased by members of the general public with after-tax dollars.

The first variable annuity in America was designed and developed for a qualified retirement program offered by TIAA-CREF (now called TIAA) in 1952. As such, the variable annuity was available only as an investment within a tax-qualified plan until 1960, when the first publicly available variable annuity outside a qualified plan was developed and brought to market by the Variable Annuity Life Insurance Company (VALIC).

An annuity used in a qualified plan can provide contract owners with the same insurance benefits offered by non-qualified annuities, such as guaranteed death benefits, guaranteed living benefits, and guaranteed income payments for life. It does not, however, provide any additional tax-deferred treatment of earnings — tax deferral is provided by the qualified plan itself. (Other tax aspects of qualified and non-qualified annuities are discussed in Chapter 14: *Regulation and Taxation of Annuities.*)

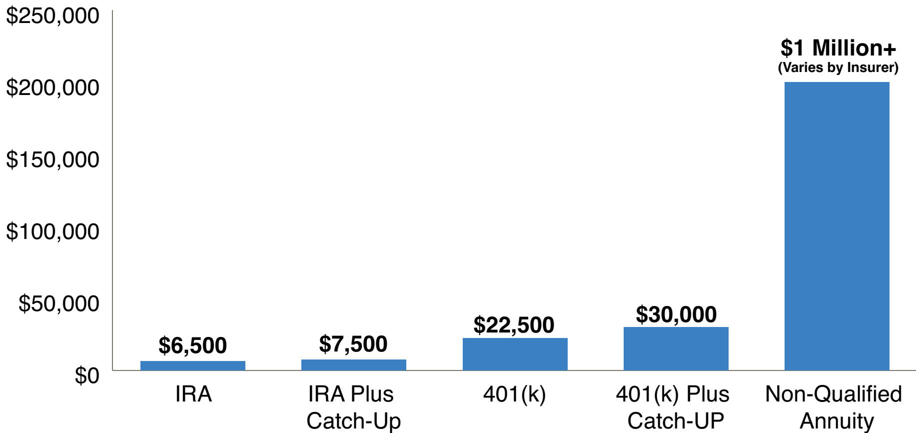
Figure 4-2 Qualified and Non-Qualified Annuities

	Qualified	Non-Qualified
Variable	• Purchased through retirement plans or IRAs using pre-tax dollars, up to specified limits. • The contract value or income payments vary based on the investment performance of underlying subaccounts. • Total sales of qualified variable annuities in 2022 were $69.1 billion.	• Purchased by members of the general public using after-tax dollars. • The contract value or income payments vary based on the investment performance of underlying subaccounts. • Total sales of non-qualified variable annuities in 2022 were $29.6 billion.
Fixed	• Purchased through retirement plans or IRAs using pre-tax dollars, up to specified limits. • Guarantees that the contract owner will earn a stated rate of interest during the accumulation phase of a deferred annuity, and receive a defined amount of income on a regular schedule when the contract is annuitized. • Total sales of qualified fixed annuities in 2022 were $111.9 billion.	• Purchased by members of the general public using after-tax dollars. • Guarantees that the contract owner will earn a stated rate of interest during the accumulation phase of a deferred annuity, and receive a defined amount of income on a regular schedule when the contract is annuitized. • Total sales of non-qualified fixed annuities in 2022 were $91.6 billion.
Total	• Total sales of qualified annuities in 2022 were $181.0 billion.	• Total sales of non-qualified annuities in 2022 were $121.2 billion.

Source: Morningstar, Inc.; Beacon Research

Annuities used within qualified plans are subject to annual contribution limits (Figure 4-3 shows the limits for 2023). The government does not, however, limit the total annual amount of premium payments to non-qualified annuities. Insurance companies may impose maximum premium limits that are typically very high and do not affect most contract owners. Because of this feature, many people view non-qualified annuities as valuable personal retirement accounts to which they can contribute as much as they need for retirement.

Figure 4-3 Retirement Savings Plan Contribution Limits – 2023



Source: Internal Revenue Service – *Publication 590, Individual Retirement Arrangements*

Are Annuities Sold Outside of the Retail Market?

In addition to the annuities described above that are sold through the retail market, several annuities are sold through institutional or private markets. This includes group annuities as well as lesser-utilized annuity products such as private annuities, private placement annuities, and charitable gift annuities. While most of the remainder of the IRI Retirement Fact Book concentrates on individually sold annuities, a brief mention of these additional types of annuities is included for informational purposes.

Group Annuities

Group annuities are typically used as a retirement income plan for employees. Unlike annuities sold in the retail market, group annuity contracts are generally owned by the employer, and employees are participants. Certain individual annuities used in 403(b) plans may also be referred to as "group annuities," but these are actually individually owned contracts purchased in a group setting and contributed to via payroll deduction, for example in the case of a retirement plan for employees of a university or hospital. Group annuities are covered in more detail in Chapter 12: *Tax-Qualified Retirement Plans*.

Private Annuities

In the United States, all commercial annuities are issued exclusively by insurance companies. A "private" annuity is not issued by an insurance company. Rather, it involves the transfer of property (such as real estate) from an individual or a revocable living trust in exchange for an unsecured promise by the transferee (an individual or a non-insurance entity, such as a trust) to make a periodic stream of fixed payments. The tax treatment of private annuities is complex and differs from the tax treatment of commercial annuities.

Private Placement Annuities

Private placement annuities are variable annuity contracts that are not registered under federal or state securities laws. They are available exclusively to investors who meet certain minimum net worth and income levels under such laws. The types of investment options available under private placement annuity contracts often include hedge funds, commodities, managed accounts, and other kinds of private equity offerings.

Charitable Gift Annuities

With a charitable gift annuity, a donor transfers cash or property (including appreciated property) to a charitable organization in exchange for income payments for life or joint lives, with no guarantee period. The federal tax law imposes specific requirements on the relationship of the amount donated and the value of the promised annuity stream. The charity can fund its payment obligations using its own assets, or it can fund them by purchasing a commercial annuity.

What Fees and Expenses Are Associated With Annuities?

What Fees and Expenses are Associated with Fixed Annuities?

A fixed annuity typically does not impose direct expense charges on the contract owner, other than surrender charges (charges for cancellation of the contract during its early years) for deferred fixed annuities. The spread, or difference between what the issuing company expects to earn and what it commits to pay out is intended to cover the insurer's expenses.

What Fees and Expenses are Associated with Variable Annuities?

A variable annuity, on the other hand, involves direct expenses in the form of insurance charges and indirect expenses in the form of management and other fees and expenses associated with the underlying mutual funds in which the variable annuity subaccounts invest.

Insurance, Administrative, and Distribution Charges

The fees and charges commonly associated with variable annuities include mortality and expense risk charges (M&E fees), administrative charges, and distribution charges.

In most contracts, the M&E fee pays for three important insurance guarantees:

- The ability to choose a payout option that provides an income that cannot be outlived at rates set forth in the contract at the time of purchase
- When available, a death benefit to protect beneficiaries
- The promise that the annual insurance charges will not increase

The administrative and distribution charges pay for all of the services involved in the maintenance of variable annuity contracts, such as the preparation of contract statements and mailings and other customer services. Some variable annuities also impose an annual contract fee that is similar to the annual account maintenance fee imposed by many IRAs. This fee generally ranges between $30 and $40 per year. Most insurers waive this fee for contracts with an accumulation or contract value of at least a certain amount, e.g. $25,000.

Mutual Fund Fees and Expenses

Underlying mutual funds incur investment management fees and operating expenses, and in many cases, distribution charges known as “12b-1 fees,” which are named after the SEC rule that governs them. Investment management fees for the mutual funds that underlie the subaccount investment options in variable annuities are, on average, lower than those charged for publicly offered mutual funds. These lower fees have the effect of offsetting, to some extent, the insurance charges. See Chapter 9: Focus on Accumulation with Income Flexibility, for illustrations show how projected accumulation values can vary between variable annuity and mutual fund portfolios.

Surrender Fees

If a contract owner decides to cancel a deferred annuity during the early years of the contract, surrender charges may apply. These charges, if applicable, generally begin in a range from 5 percent to 7 percent of the amount invested and decline to zero over a period of time, such as five to seven years. Surrender charges are structured differently for different annuity products. (See the following section, How Are Variable Annuity Sales Charges Structured?)

Unbundled Fees

Some variable annuity contracts permit purchasers to select from a menu of optional product features, each of which usually has an associated charge. This unbundling approach gives customers the ability to select and pay for only those features they want. Optional features, referred to as riders, include, for example, enhanced guaranteed death benefits and guaranteed minimum living benefits. These riders typically have a separate, additional fee. See Chapter 8: Planning for Future Income, for data on these optional contract rider fees.

Premium Tax

States may impose premium taxes on variable annuity purchases. Currently California, Maine, Nevada, South Dakota, West Virginia, and Wyoming tax life insurance and annuity premiums, and only California and West Virginia tax qualified purchases. Tax rates range from 0.5 percent (California on qualified monies) to 3.5 percent (Nevada on non-qualified). Florida assesses a 1 percent tax on both qualified and non-qualified monies, but it is typically absorbed by the issuing insurance company.

How Are Variable Annuity Sales Charges Structured?

B-Share Variable Annuities

Most variable annuity contracts are B-share products. They are offered with no initial sales charge, but cancellation of the contract during its early years may trigger a withdrawal charge known as a surrender charge. These charges typically range from 5 percent to 7 percent of premium in the first policy year, and subsequently decline to zero, generally after five to seven years (known as the surrender charge period). Some annuity contracts impose surrender charges only during the initial surrender charge period that begins after the contract is purchased, while others associate a new surrender charge period with each subsequent premium payment.

Surrender charges underscore the long-term nature of the annuity product. As long as contract owners remain committed to accumulating money for retirement through their variable annuity, they generally will not incur these charges. In addition to surrender charges, B-share contracts have annual M&E and administration fees. B-shares accounted for over 80 percent of variable annuity sales in 2022.

A number of insurers have begun to offer other types of charge structures to meet different investor needs. The following are the most common.

A-Share Variable Annuities

Like A-share mutual funds, A-share variable annuities have up-front sales charges instead of surrender charges. Sales charges are calculated as a percentage of each premium payment.

A-share variable annuities offer breakpoint pricing, which means up-front sales charges decrease depending on the cumulative amount of purchase payments that have been made. In addition, assets that a contract owner has in other products in the company's product line may be recognized in the cumulative payment amount used to determine the breakpoint pricing. A-share contracts often have lower ongoing M&E annual fees than annuities with surrender charges. A-shares accounted for less than one percent of total VA sales in 2022.

C-Share or No-Surrender-Charge Variable Annuities

C-share, or no-surrender-charge variable annuities, offer full liquidity to owners at any time, without any up-front or surrender charges (although tax penalties may apply to withdrawals before age 59½). There are, however, ongoing M&E and administrative fees. C-shares made up about two percent of total VA sales in 2022.

I-share or Fee-Based Variable Annuities

I-share, or fee-based variable annuities, are intended for investors who favor paying one fee to have their investment portfolio managed by a registered investment advisor or fee-only advisor, (for example, a wrap-fee advisory program). Typically, the sale of an I-share does not result in a sales commission for an advisor from the issuing insurance company. However, the advisor assesses fees for the services, including the I-share contract, which is agreed upon by the client. Consequently, M&E annual fees are generally less than other share-classes due to the absence of commissions. I-shares have no surrender charges and may provide optional living benefit guarantees for an additional fee. I-share sales are a larger percentage of the VA market than they were several years ago; sales of I-shares have grown as overall VA sales have dropped, so I-shares are about eight percent of the VA market today versus three percent 10 years ago.

L-Share Variable Annuities

L-share variable annuities have no up-front sales charges. They typically have relatively short surrender charge periods, such as three or four years, but may have higher ongoing M&E and administrative charges than other share classes. It is becoming more common for L-shares to be structured as a B-share with an optional "buy down," which reduces the duration of surrender charges for an additional fee. This "liquidity rider" expires when the shortened surrender charge period is over, as does its fee. L-shares once accounted for almost one-third of the market but have almost disappeared from the VA landscape due to suitability concerns and represented less than 1 percent of total VA sales in 2022, with almost all this likely coming from additional purchase payments to existing contracts rather than new sales.

O-share Variable Annuities

O-shares are intended to merge the advantageous M&E and surrender charges of A-share and B-share variable annuities, respectively. Unlike A-shares, O-shares do not impose up-front sales charges, while, typically, possessing surrender charge periods akin to B-shares. Instead, M&E charges are assessed against both the account value and the premium, with the premium-based charges progressively declining throughout the surrender period, and ending after the surrender period. These features result in expenses similar to an A-share once the contract is free of surrender charges. The design of O-shares encourages investors to think of variable annuities as a long-term investment by rewarding longer holding periods with lower fees. O-shares were less than three percent of sales in 2022.

X-Share (Bonus) Variable Annuities

X-Share variable annuity contracts credit an additional amount or bonus to the contract value, which is calculated as a percentage of purchase payments added to the contract at or subsequent to contract issue. Bonus amounts generally range from 1 percent to 6 percent. For example, with a 3 percent bonus feature, a contract owner paying $10,000 in premiums would have $300 credited immediately to the balance. This category does not include contracts that credit additional amounts to the contract value after a designated period, sometimes referred to as "persistency bonuses." Variable annuities with bonus credits may have higher ongoing expense charges and longer surrender periods than variable annuities without bonus credits. Some contracts allow the insurer to re-capture all or part of the bonus if the contract is surrendered within the first few years. Bonus contracts are difficult for companies to offer in a low interest rate environment, and there are far fewer available than there once were. There are only a few X-shares available for new purchase, and the class accounted for about one percent of total sales in 2022; as with L-shares, most if not all of these sales represent additional premiums paid into older X-share variable annuities.

What Are Guaranteed Minimum Death Benefits?

If a contract owner dies in the accumulation phase, a deferred annuity contract will, at a minimum, pay the accumulation value to a named beneficiary. Sometimes the contract may be continued by the beneficiary, with the beneficiary as the new owner. The contractual payout of this benefit varies by policy and can be payable as a lump-sum payment or as periodic annuity payments. (Fees associated with death benefits are discussed in Chapter 8: Planning for Future Income. The tax treatment of death benefits is discussed in Chapter 14: *Regulation and Taxation of Annuities.*)

Most, but not all, variable annuity contracts provide a standard Guaranteed Minimum Death Benefit (GMDB) during the accumulation period equal to the greater of (a) the contract value at death or (b) premium payments minus any prior withdrawals. The "return of premium" (ROP) GMDB gives contract owners the confidence to invest in the stock market, important in keeping up with market inflation, as well as the security of knowing their families will be protected against financial loss in the event death occurs as a time when the account value has incurred losses due to negative market returns.

The value and importance of the death benefit is periodically highlighted during major market corrections, such as the COVID-19 precipitated selloff in equity markets in March 2020; the financial crisis in 2008; or the technology stock led market downturn between 2001 and 2003. While markets inevitably recover and historically go on to reach new highs (as they certainly did in 2021!), the beneficiaries of variable annuity contracts owned by those who die during or

immediately after a huge selloff are protected. During each of these major market corrections, variable annuity beneficiaries received death benefits worth significantly more than the value of the annuities, protecting annuity value for beneficiaries. For a VA contract owner dying in a "trough" of financial market returns, the preservation of assets for heirs afforded by a GMDB, even a standard ROP, can be quite significant: estimates of unhedged GMDB exposure at the height of the 2008-2009 financial crisis were as high as $15 billion, meaning $15 billion of death benefit liability in excess of variable annuity account value. A similar circumstance occurred at the onset of the pandemic; contract owners who died in the early months when the market dropped precipitously before recovering were protected from those losses. Beyond ROP there are also several types of enhanced GMDBs that provide additional growth and/or protection of account value. The different types of enhanced GMDBs are described below, some of which have additional associated charges.

Contract Anniversary Value or Ratchet

Some life insurance companies offer death benefits that step up or increase based on pre-determined criteria. Called contract anniversary value or ratchet, these enhanced GMDBs are equal to the greater of (a) the contract value at death, (b) premium payments minus prior withdrawals, or (c) the contract value on a specified prior date. The specified date could be a prior contract anniversary date, such as the date at the end of every seven-year period, every anniversary date, or even more often. A ratchet GMDB locks in the contract's gains on each of the dates specified.

Initial Purchase Payment With Interest or Rising Floor

Some insurers offer a rising floor GMDB that is equal to the greater of (a) the contract value at death or (b) premium payments minus prior withdrawals, increased annually at a specified rate of interest. In some cases, a ratchet and a rising floor may be available within the same contract. Some contracts offer a choice of a ratchet or a rising floor. Though they have become less common and more expensive in recent years due to low interest rates, they are still available.

Enhanced Earnings Benefits

Not all variable annuity death benefits are associated with protection against falling markets. Many variable annuity contracts offer enhanced earnings benefits (EEB) that provide a separate death benefit to help offset federal and state income taxes payable upon death on any gains in the contract. With this feature, beneficiaries receive not only the base death benefit amount, but also an additional amount that is usually equal to a percentage of the contract's earnings at death, e.g., 40 percent.

What Are the Different Types of Guaranteed Minimum Living Benefits?

Prior to 1997, principal protection under variable annuity contracts was offered only in the case of death. In 1997 the first Guaranteed Minimum Income benefit was issued by Equitable, which offered contract holders the opportunity to generate annuity income from the greater of the account value or a guaranteed minimum amount based on the premium, after a multi-year waiting period. In subsequent years insurers developed other "living protection" against investment and/or longevity risk in variable annuity contracts by guaranteeing minimum accumulation values or withdrawal amounts. Some type of living benefit rider is offered on about two-thirds of "open" (i.e., available for new purchases) variable annuity contracts.

Various types of guaranteed minimum living benefit (GMLB) riders are described below. Besides offering these in new contracts, some companies allow them to be added to existing contracts. Guaranteed living benefits are usually offered as riders to variable annuity contracts for an optional charge. (Fees associated with guaranteed living benefits are discussed in Chapter 8: *Planning for Future Income.*)

Guaranteed Minimum Income Benefit

A guaranteed minimum income benefit (GMIB) rider is designed to provide the investor with a base amount of lifetime income when they retire regardless of how the investments have performed. It guarantees that if the owner decides to annuitize the contract (for life, life plus a certain period, or the lives of two people), payments are based on the greater of the contract value, or the amount invested credited with simple or compound “interest” at a rate of 1 percent to 3 percent. The “interest” creates a notional balance upon which annuity payments can be calculated; it does not represent account or cash value. An investor must annuitize to receive this benefit and there is typically a 10-year holding period before it can be exercised. Age limits may also apply.

Guaranteed Minimum Accumulation Benefit

A guaranteed minimum accumulation benefit (GMAB) rider guarantees that an owner’s contract value will be at least equal to a certain minimum percentage (usually 100 percent) of the amount invested after a specified number of years (typically 10 years), regardless of actual investment performance.

Guaranteed Minimum Withdrawal Benefit

First introduced in 2002 by The Hartford, a guaranteed minimum withdrawal benefit (GMWB) rider guarantees that a certain percentage (usually 4 percent to 6 percent) of the amount invested can be withdrawn annually until the entire amount is recovered, regardless of market performance. Reducing withdrawals in one year generally does not allow for increased withdrawals in subsequent years. However, if a contract owner defers withdrawals and the account value grows and is “locked in” at certain points as the new “benefit base,” the subsequent withdrawal amounts allowed may be larger.

If the underlying investments perform well, there will be an excess amount in the policy at the end of the withdrawal period. If they perform poorly and the account value is depleted before the end of the withdrawal period, the investor can continue to make withdrawals until the full amount of the original investment is recovered.

If the investor decides to terminate the contract before the end of the withdrawal period, he or she will receive the cash surrender value of the contract.

Guaranteed Lifetime Withdrawal Benefit

Another type of GMWB rider that guarantees withdrawals for life was introduced in 2004. The guaranteed lifetime withdrawal benefit (GLWB) guarantees that a certain percentage (typically 3 percent to 5 percent, often based on age) of the amount invested can be withdrawn each year for as long as the contract holder lives. This percentage may vary depending on the person’s age when withdrawals begin, whether the payment is guaranteed to continue for the life of one (single life) or two (joint life) individuals, and in some of the newest structures based on the level of an external benchmark such as the 10-year Treasury Constant Maturity Rate. More recently issued benefits may also include other levers that help the insurance company manage the risk of guaranteeing lifetime income on a variable annuity, such as a reduction in the withdrawal percentage rate if the account value is exhausted while income payments are still being made.

In many GMLBs, “step-up” features periodically, e.g., annually or every five years, lock in higher guaranteed withdrawals if investments do well. “Roll-up” features, conversely, increase the amount that may be withdrawn (by increasing the “benefit base” used to calculate withdrawals) during the deferral period, i.e., prior to the commencement of withdrawals. Allocation to a balanced or volatility managed fund, adherence to an asset allocation program, or a minimum allocation to a fixed or fixed income subaccount is often required when electing a GMLB. The liability risk to the insurer may also be managed through dynamic rebalancing, which shifts allocation toward more conservative investment options when equity returns are negative and/or market volatility increases.

In-Plan Lifetime Income Benefit

The standalone lifetime income benefit (SALB) was introduced in 2008. While the SALB did not get much traction in the individual market, the framework has evolved into a defined contribution plan option that embeds a lifetime income benefit into a target-date fund. Since this is not an annuity per se, under current law it is eligible as a Qualified Default Investment Alternative (QDIA), which participants can be auto-enrolled in with the option to opt out if they so choose. This provides in-plan income protection similar to that provided by GLWB on an individually purchases annuity, enabling retirement savers to create their own pensions within workplace plans. Combined with the SECURE Act and SECURE 2.0, which helped alleviate fiduciary concerns by providing a safe harbor for plan sponsors, strong growth is expected in this area in the coming years (see Chapter 14: Regulation and Taxation of Annuities, for more information about the SECURE Act).

Long-Term Care Protection

Some annuity contracts have features designed to address aging Americans’ concerns about long-term care (LTC). Many contracts permit owners to withdraw money from their contracts for long-term care needs without incurring surrender charges. Surrender charges may be waived if, for example, a contract owner has been confined to a nursing home for a minimum period or has suffered a critical illness. Some variable annuity contracts provide GLWB features that double the income payment during a qualified long-term care event, for example admission to a long-term care facility or the inability to perform the Activities of Daily Living (ADLs). Additional benefits may also be offered, such as eldercare resources, referral and consultation services, and discounted long-term care services from a specified group of providers. Hybrid annuity/long-term care products can provide valuable protection against the impact of long-term costs to consumers for whom traditional long-term care may be unaffordable, or unobtainable due to pre-existing conditions.

With the enactment of the Pension Protection Act of 2006, new hybrid products that combine annuities with LTC were introduced. Beginning in 2010, tax-free distribution status was given to both annuity assets and LTC rider benefits used for a qualified LTC purpose. Under prior law, withdrawals taken from the annuity to pay the LTC premiums were taxable and subject to a 10 percent penalty prior to age 59½.

How Is the Value of a Deferred Annuity Determined?

The accumulation period begins when the initial purchase (or premium) payment is made by the contract owner and the contract is issued by the life insurance company. Gifts, an inheritance, or any other source of income can be used to initiate or add to a contract. Typically, insurance companies have minimum requirements for initial and additional premium amounts. However, sometimes a life insurance company will permit a smaller minimum initial payment, for example,

$1,000, if the purchaser agrees to pay premiums on a regular basis, e.g., through automatic payroll deduction. Insurers may also have lower minimum premium requirements for annuities in qualified retirement plans such as 403(b) or 401(k) plans. As is true for all qualified plans, contributions to annuities used to fund qualified plans must come from earned income.

How Is the Value of a Variable Annuity Measured?

The value of a contract owner's variable annuity is equal to the sum of the contract owner's account values in all the variable investment options or subaccounts plus the value of any amounts allocated to available fixed account options, if any.

Unit Values

Each subaccount has a unit value, which is similar to the net asset value (NAV) of a mutual fund. The unit value measures the numerical worth of the assets in a subaccount, per unit of the subaccount owned. The unit value increases or decreases, respectively, with the positive or negative investment performance of the underlying mutual fund in which the subaccount invests and is reduced by insurance charges and the fees and expenses of the underlying mutual fund. Unit values vary among the subaccount options inside a variable annuity. A contract owner's account value allocated to a particular subaccount is equal to the number of units of the subaccount owned multiplied by the current unit value.

Unit values apply to variable annuities in both the accumulation phase and the payout phase. Although the specific unit values differ between the accumulation and payout phases, the concept is the same. During the payout phase, contract owners are entitled to receive a determined number of units of benefit, which translate into an income payment amount based on the unit value at the time of payment. The unit value and resultant income payment may increase or decrease due to investment performance.

Variable Investment Options

Variable annuities offer investment choices called subaccounts, a selection of funds similar to publicly sold mutual funds, often managed by the same fund managers (most variable annuities also offer a fixed account, effectively an embedded fixed annuity, within the variable contract). The value of the subaccounts will fluctuate over time, and the variable annuity's return will be based on the investment performance of those subaccounts.

A variable annuity contract will generally permit the owner to choose from a range of subaccounts with different asset classes and strategies. The choices may include equity funds, bond funds, balanced funds, money market funds, and specialty funds such as international and sector funds.

The subaccounts are often managed by a variety of investment advisors, who may or may not be affiliated with the insurance company. Most of the largest mutual fund companies, and many smaller shops, offer subaccounts that serve as investment options or provide professional fund management services for variable annuities.

Variable Annuity Portfolio Allocation

Variable annuities offer investors a wide variety of funds to choose from to match their risk tolerance and views of the market. There are different types of asset allocation programs available to help variable annuity purchasers analyze their risk tolerance and decide on a specific mix of funds. Choosing the right mix can be a complex process.

Portfolio Rebalancing

Once a contract owner has decided on the investment mix best suited for his or her needs, premium payments are allocated in accordance with those percentages. However, as time goes by, market performance may alter the percentage of the variable annuity's contract value held in certain subaccounts (e.g., equity exposure may be significantly higher after a period of strong stock market returns). Many variable annuity issuers offer programs that automatically maintain a pre-determined investment diversification based on the specific needs of each investor. These programs, referred to as portfolio rebalancing programs, periodically reallocate variable annuity contract assets among fixed and variable investment options to reflect the proportions originally selected.

Dollar Cost Averaging

Contract owners who are wary of investing when the market is at a peak can take advantage of dollar cost averaging programs offered under many variable annuity contracts. An owner may choose to allocate a substantial portion of his or her premium payments to a particular stock fund. If the allocation is made all at once, it is possible that a single purchase price could be locked in when asset values of the stock fund are relatively high. With dollar cost averaging, the premium is systematically transferred (typically from the variable annuity's fixed account option or a money market option) to one or more stock, bond, or balanced funds over a specified period of time, with the goal of investing at lower, as well as higher, prices. While dollar cost averaging does not ensure a profit or protect against a loss, it can be an effective investment technique.

Importance of Tax Deferral to Portfolio Allocation

The benefits of tax deferral are vital to rebalancing programs and dollar cost averaging. In a taxable account, such as a stand-alone mutual fund, each time an investor sells a stock, mutual fund, or other investment, and replaces it with another in order to reallocate assets, the investor can be required to pay short- or long-term capital gains tax on any investment growth. With a variable annuity, an owner can rebalance between funds as desired without being taxed, thereby maximizing investment potential.

Transfers

While variable annuity contract owners may transfer money, tax free, from one investment option to another during the accumulation period, certain restrictions typically apply. Owners may be restricted to the number and amount of transfer payments allowed in any given year from a fixed account contained inside a variable annuity contract. Another restriction may also limit the number of transfers made among the variable investment options within a specified period of time. Transfers in excess of such limits may be subject to nominal administration charges or alternative transfer request methods, such as a requirement to send such requests via U.S. Mail versus online or telephonic instruction.

How Is the Value of a Fixed Annuity Measured?

Fixed annuities offer a rate of return that is determined by the insurance company for a set period of time, subject to a specified minimum. When the applicable period is over, the company may offer a new rate for the next period, which can be for a different length of time. Fixed annuities generally specify a minimum credited interest rate for the lifetime of the contract.

There are several types of deferred fixed annuities available, each with its own method of crediting interest.

- *Book value deferred* products earn a fixed rate for a guaranteed period. The surrender value is based on the annuity's purchase value plus credited interest, net of any charges.
- *Market value adjusted* (MVA) annuities are similar to book value deferred annuities, but the surrender value is subject to a market value adjustment based on interest rate changes.
- *Fixed indexed annuities* (FIA) guarantee that a certain rate of interest will be credited to premiums paid but also provide additional credited amounts based on the performance of a specified market index (such as the S&P 500).

Individual fixed indexed annuity contracts have additional interest crediting provisions. These include:

- *Crediting method* — the method used to measure the change in the underlying index, e.g., point-to-point or annual reset.
- *Participation rate* — the percentage of the calculated index gain credited to the contract owner as interest. This can be guaranteed or eligible for reset.
- *Spread/Margin* — the percentage by which the gross index gain is reduced before being credited to the contract owner as interest.
- *Cap* — the maximum index-based interest credited to the contract owner. This can be guaranteed or eligible for reset.
- *Volatility Controlled Indexes* — custom indexes intended to mute the effect of ups and downs in the markets they track; may be used instead of, or in conjunction with, participation rates, caps, and spreads.

What Happens to the Annuity Value if the Contract is Surrendered?

Deferred annuity contracts permit the contract owner to surrender the annuity contract during the accumulation period and receive a cash payment from the insurance company. This amount is called the cash value or cash surrender value of the contract. It equals the sum of premiums paid plus any earnings, minus prior withdrawals and charges deducted. The owner may take partial withdrawals or fully surrender the contract during the accumulation phase. Penalties for early withdrawal may be incurred and federal income taxes will apply to any gain in the contract value. The amount paid to the contract owner on surrender may be subject to surrender charges, which generally range from 5 percent to 7 percent. Some deferred annuity contracts impose surrender charges only for an initial period after the contract is purchased; others start a new surrender charge period for each individual premium paid. Surrender charges usually decline to zero over a period of time, such as five or seven years.

A partial surrender is the withdrawal of an amount less than the entire cash surrender value of the contract. Partial surrenders can also be taken as a pre-scheduled series of payments under a systematic withdrawal plan. Many contracts permit annual withdrawals of an amount, such as 10 percent of the contract value, free of a surrender charge. Tax penalties may apply, however, in the event such withdrawals occur prior to the contract owner reaching age 59½.

How Are Annuities Used to Generate Retirement Income?

While much of the focus on annuities in recent years has been on their value as a savings vehicle for retirement, their value as a source of lifetime income during retirement is equally important. Traditional sources of guaranteed retirement income are diminishing at the same time retirees are living longer, more active lives. This places the burden on individuals to both carefully save for retirement and wisely manage their investments during retirement, so their money lasts as long as they live. How retirees decide to receive income from their annuities once they retire can play an important role in achieving this outcome.

What Are the Various Options for Receiving Retirement Income?

Once a person is ready to retire, annuities offer a number of retirement income options. The contract owner can choose to receive all the assets from the annuity at once, opt for a series of withdrawals of his or her choosing until all the assets are exhausted, or decide to exercise the annuitization features of the contract.

The following information pertains to non-qualified annuities that are purchased with after-tax dollars. While the payout options available are the same for annuities purchased as part of qualified retirement plans, as discussed in the last section of this chapter the tax consequences are different.

Lump-Sum Option

When a contract owner elects a lump-sum distribution, the annuity is surrendered and all assets are withdrawn from the contract. Taxes will be due on earnings in the year the money is received, and tax penalties may apply to withdrawals before age 59½. With this option, individuals are still faced with the need to generate a guaranteed stream of income.

Systematic Withdrawal Plan

With a systematic withdrawal plan, the assets are left in the annuity and the contract owner receives distributions at regular intervals until the assets have been exhausted or the contract owner elects to suspend the operation of the plan. All earnings on the investment are considered to be distributed before any return of principal and are taxable at ordinary income tax rates. Assets remaining in the annuity continue to grow tax deferred until withdrawn.

The principal advantages of a systematic withdrawal plan are the flexibility provided to the contract owner and the ability to maintain full ownership of the assets. The principal disadvantage is that the contract owner retains the risks associated with both uncertain longevity and investment fluctuations, particularly the exposure to adverse market performance during the early stages of retirement.

If a specified dollar amount is withdrawn each period, whether adjusted for inflation or not, the contract owner assumes the full risk of market cycles. The very principles that recommend dollar cost averaging as a successful strategy for entering the market work against the contract owner in a liquidation strategy. Withdrawal of a fixed dollar amount means that a higher percentage of assets will be liquidated in a down market than in an up market. This can be a very dangerous strategy, even if long-term investment performance meets anticipated targets, since the withdrawal of assets in earlier years can prevent the overall portfolio from achieving the projected return.

The withdrawal of a specified percentage of assets rather than a specified dollar amount may help reduce this risk. Many people plan their retirement income based on an average rate of return on their investments (such as 8 percent). If they happen to retire during a time of far lower (or even negative) returns, however, the specified percentage of assets they withdraw may not provide sufficient income to maintain their desired lifestyle. To help reduce the impact of market fluctuations on retirement income, it is important for retirees to have a variety of diversified investments in their portfolios, including annuities, which can help create a guaranteed source of income that will last as long as they live.

Guaranteed Withdrawals

Contract owners electing a guaranteed minimum withdrawal benefit (GMWB) rider can choose to receive the value of their investment through annual withdrawals (up to a set percentage) at least until the entire amount invested is completely recovered. Contract owners electing a guaranteed lifetime withdrawal benefit (GLWB) can choose to withdraw a percentage of their contract value each year for as long as they live, even if the account value is exhausted. Distributions are deemed to represent investment earnings until total payments equal the account value in excess of total purchase payments and are taxable at ordinary income tax rates, after which time payments are deemed return of principal and are not taxed. Payments made by the insurance company after the account value is reduced to zero are deemed ordinary income and taxed as such.

Contract owners electing these benefits have greater control over their assets but may receive lower monthly payments than if they annuitize. While some GLWBs are beginning to tailor the percentage withdrawal to the age of the contract owner, it is only through annuitization that an investor can maximize the benefit of mortality risk pooling.

Annuitization

Annuitization involves turning the contract owner's accumulated assets into a stream of income based on the amount of the contract, the annuitant's age, payout choices, etc. The insurance company guarantees that it will provide payments for the life of the annuitant(s). With a deferred annuity, money is saved and invested during the accumulation period, and then annuity payments are received during the income period (e.g., during retirement). With an immediate annuity, payments begin immediately or within one year after the annuity is purchased. Payments can be either fixed or variable and guaranteed for one person's life, for the lives of two people, and/or for a specified period. Payments may also be structured with a cash refund feature, which provides for a payment to beneficiaries of an amount equal to the difference between the annuitized amount and the total payments made prior to the annuitant's death, should death occur before payments at least equal the amount annuitized.

Deferred Income Annuities

With a deferred income annuity (sometimes called longevity insurance), a retiree can purchase a contract at one point in time, for example, at age 65, but defer payments until a later time, for example, at age 85. Individuals not living until the commencement age will not receive benefits;

and individuals who do live to the required age and beyond, will receive income payments. Because these products usually have no death or living benefits, and not all contract owners will live long enough to collect income, insurance companies can maximize insurance leveraging (risk pooling) and thus make larger income payments to retirees still living. Recent innovations include optional death benefit and joint and survivor payments, but the trade-off is a higher premium or smaller monthly payments. The issuance of new regulations from the U.S. Treasury in June 2014, the "Qualified Longevity Insurance Contract" rules, provided clarity around the use of these products in qualified plans by establishing a deferred income annuity purchase amount limit of the greater of 25 percent of account value or $125,000 and created provisions for the addition of a death benefit and the ability to reverse an excess purchase payment in order to avoid tax penalties. The SECURE 2.0 Act removed the 25 percent limitation and increased the QLAC purchase limit to $200,000 for 2023.

What Are the Benefits of Annuitization?

By exercising the annuitization option of a deferred annuity (or by purchasing an immediate annuity), the contract owner can transfer the longevity risk to the insurance company and, if a fixed annuity is chosen, the investment risk as well.

As mentioned earlier, annuities are the only financial instruments available today, other than Social Security and pensions, that can guarantee a lifetime stream of income during retirement. Annuitizing a portion of retirement savings provides retirees with an effective hedge against outliving their assets. And because annuity owners are part of a mortality pool, the annuity payments received are larger than they could generate by saving on their own and systematically withdrawing funds in amounts that give them a reasonable assurance of not running out of money.

As part of a comprehensive retirement portfolio, annuities both reduce the risk of running out of money if a person lives a long life and increase the amount of each income payment received.

What Types of Annuity Payout Options Are Typically Available at Annuitization?

One of the first choices contract owners may have to make once they decide to annuitize is whether to receive fixed or variable payments. Owners of deferred fixed annuities can elect only a fixed payout option. Owners of deferred variable annuities, however, can sometimes choose either fixed or variable payouts. Once a selection is made, it is usually irreversible. With fixed payments, the insurance company sets a given amount it will pay (typically monthly) for the term of the contract. With variable payments, the amount of each payment is not guaranteed but changes with the performance of the underlying portfolio selected by the contract owner. Fluctuations in these payments can sometimes be reduced by opting for level payments (which hold payments level for a certain period of time) or stabilization guarantees (which provide a floor below which payments will not fall).

Life Annuities

A life annuity provides an income stream guaranteed to last as long as the annuitant lives. Under a straight or pure life annuity, annuity payments stop when the annuitant dies. A joint and survivor annuity (often selected by spouses) provides income for as long as either of the two annuitants is alive, although the amount of each payment will be less than if the payment were based on a

single life. Payments can stay the same or decrease after the death of the first annuitant. Under a joint and two-thirds annuity, each payment made after the death of the first annuitant is two-thirds of the amount paid while both annuitants were alive. This can be an effective strategy, as it results in a higher payment when both annuitants are alive and expenses will likely be lower for one person than for two.

As discussed previously, a valuable feature of an annuity is the fact that it can generate higher income payments than an individual systematic withdrawal plan and continue payments for as long as a person lives. But what about the investor who does not live long enough to receive many payments? There are a number of options for mitigating this risk. Each, however, results in a lower basic periodic payment.

Period Certain Annuities

With a period certain annuity, payments are guaranteed to continue for a specified time, for example, 10 years, no matter how long the annuitant lives. If the annuitant dies before the period has expired, payments continue to the designated beneficiaries for the remainder of the period. Period certain annuity payments typically are available for periods from five to 30 years. This option, however, offers no protection against longevity risk as payments are only made for the fixed period selected.

Life Annuities With a Period Certain

Life annuities with a period certain option guarantee payments for the life of the annuitant, but also guarantee that these payments will continue for a set period of time if the annuitant dies before the period has expired. Payments continue to the designated beneficiaries until the guarantee period has ended.

Cash Refund Annuities

With a pure life annuity, payments stop when the annuitant dies. In the most extreme case, an annuitant could die after one payment is made. Some annuitants prefer to hedge against this possibility by setting up a life annuity with some form of refund feature. As indicated earlier, adding such provisions results in a lower payment than would otherwise be the case.

There are two types of refund annuities now being offered that pay a refund to the beneficiary if the annuitant dies before the total of the annuity payments received equals the premiums paid for the annuity.

- *A cash refund annuity* provides for a lump sum refund of the premium minus the annuity payments already made at the time of the annuitant's death.
- *An installment refund annuity* provides that payments will continue in installments until the amount received is equal to the premiums paid.

Risk Tolerance vs. Longevity

In deciding what type of annuity payment option to choose and how much to commit to it, individuals must determine their risk tolerance with respect to their possible longevity, as well as the relative importance to them of receiving lifetime income versus leaving money to their heirs. All else equal, individuals who live beyond average life expectancy will generally realize higher income but lower estate values when using annuities versus other approaches.

How Are Variable Annuity Payment Amounts Determined?

The amount of each payment received from a fixed annuity is calculated at the time of annuitization and does not change during the life of the contract. The amount of each variable payment, on the other hand, fluctuates based on the investments chosen. Since the investment return of the portfolio cannot be determined in advance, some assumptions must be made in order to calculate the amount of the initial payment under the contract. This is accomplished by selecting an assumed interest rate, or AIR. After the initial payment, each subsequent payment is determined by adjusting the previous payment up or down based on the actual performance of the underlying portfolio for the period of time in question. If the portfolio earns more than the AIR, the subsequent payment will increase. If the portfolio earns less, the payment will decrease. If it earns the same amount, the payment will stay the same.

Some contracts set the AIR, but most allow the contract owner to choose from a range (usually 3 percent to 6 percent), the outside limits of which are set by state regulations. Selecting a low AIR will cause payments to increase faster with higher positive returns, or decline more slowly with low or negative returns, than if a higher AIR were selected. However, the initial income payment will be less than if the higher AIR were selected.

Level Annuity Payments

Some variable annuity contracts provide payment streams that can be adjusted at periodic intervals of up to 12 months, rather than monthly, to provide the annuitant with an element of certainty. This allows the annuitant to plan on a given level of payments for the period in question. When the periodic adjustments are made, however, they are likely to be more substantial than if the adjustments had been calculated more frequently.

Payment Stabilization Guarantees

Other variable annuity contracts offer payments supported by “floors.” These floors guarantee that subsequent payments will never be less than a given percentage of the original payment e.g., 85 percent or 100 percent, regardless of the performance of the underlying portfolio. Some provisions, limit the investment choices underlying the annuity, providing the insurance company with the opportunity to hedge its guarantee with derivative instruments. These floors provide contract owners with a safety net that may make them more comfortable with having their annuity payments subject to the variability of stock market performance. If a contract owner chooses this feature, however, payment amounts will be lower than if no floor were elected.

Liquidity Options

Historically, once an annuity contract was annuitized the stream of payments could not be altered. Some insurance companies now offer life annuities that allow annuitants who have also selected a period certain option to receive an advance of a given percentage of income payments, subject to certain restrictions that vary by company. These partial commutations, as they are called, reduce the remaining annuity payments. Some companies also allow the liquidation of the entire annuity, converting the value of the future stream of income into a lump-sum payment. If this option is exercised, all future payments cease.

How Are Annuity Payments Taxed?

If an annuity (fixed or variable) was purchased with non-qualified or after-tax dollars, a portion of each payment is considered to be a tax-free return of principal. The remainder of the payment is subject to taxation to the extent it represents earnings. Current federal income tax law specifies that the taxable portion of annuitized payments is taxable at ordinary income tax rates.

To determine the amount of each fixed annuity payment that qualifies as a tax-free return of principal, the insurance company makes an underlying calculation based on a formula known as the "exclusion ratio." For variable annuities, since the amount of each future payment is unknown, a different calculation is performed to determine the exclusion amount.

If an annuity was purchased with qualified or pre-tax dollars using funds from a 403(b), a 401(k), or an IRA (other than a Roth or an after-tax IRA), the full amount of each distribution is taxable at ordinary income tax rates, even the amount attributable to principal.

Qualified assets, once they have been annuitized, are not subject to the required minimum distribution rules of the Internal Revenue Code since the insurance company is deemed to have already made the appropriate calculation for a lifetime distribution of the underlying assets. (See Chapter 14: *Regulation and Taxation of Annuities*, for more details on taxation.)

How Are Annuities Used in Estate Planning?

A variable annuity, while not designed as an estate planning tool, does offer some benefits in this area. An annuity avoids probate, provides flexibility when passing on assets to heirs, and can potentially increase the likelihood of leaving a larger estate in some circumstances.

Variable Annuities Avoid Probate — A variable annuity is a contract between an owner and an insurance company. The contract requires that a beneficiary be named. When a contract owner dies, there is a payout directly to the beneficiary. As a result, the annuity assets do not go through the probate process.

Probate, or the distribution of a deceased's assets via the court system, can be costly and time consuming. There are attorney fees, court costs, and administrative expenses, and the process slows the distribution of proceeds. Plus, probate proceedings are a matter of public record. Assets held in a variable annuity bypass this process and go directly to the beneficiary.

Variable annuity proceeds will be subject to probate only if the estate is named as beneficiary, when no beneficiary is named, or when a death benefit is disclaimed by the beneficiary and no contingent beneficiary is named.

The Restricted Beneficiary Option Offers Advantages — Naming a restricted beneficiary is a unique option available to an annuity owner. This enables the owner to direct the amount, frequency, and timing of the distributions. Choosing the restricted beneficiary option provides the added benefit of continued tax-deferral over the life expectancy of the beneficiary. The individuals named as beneficiaries get payouts over a period of time, during which the proceeds grow tax deferred and compound over time, potentially providing many times more from the investment than a lump-sum payout. An individual must be directly named as beneficiary to take advantage of this treatment. It is necessary to complete paperwork instructing the insurer how

to distribute the death benefit proceeds.

A Single Premium Immediate Annuity as an Estate-Building Tool — Here is an example of an annuity product that can, under some circumstances, increase the value of an estate. A single premium immediate annuity (SPIA) is usually not considered to be a vehicle that can help preserve or increase the size of an estate. Indeed, many people have the false belief that a SPIA always reduces the size of the estate. However, for those retirees who need to make regular withdrawals from their assets, a portfolio that uses a SPIA is more likely to leave a larger estate than a portfolio without it. Consider an example. Most retirees, especially as they age, place at least half of their money in fixed investments, usually bonds or certificates of deposit. Regular income is often taken from these fixed investments. As of July 2023, the average 10-year High Quality Market (HQM) Corporate Bond Spot Rate was 5.14 percent, about 40 basis points higher than at the same time last year. For a retiree to withdraw $1,000 a month ($12,000 per year) from high quality corporate bonds, that person would have to invest approximately $235,000, versus almost $500,000 before rates began to rise in 2021, illustrating the tremendous impact interest rates have on income streams during retirement. In 10 years, the retiree would still have the $235,000 investment "at par," or the redemption value of the bonds. However, the actual value of the bond holdings would be lower if rates had risen and higher if they had fallen.

However, rising rates benefit retirees using annuities for income as well. A 70-year-old male could elect to receive the same $1,000 monthly income from a SPIA with a 10-year certain period for a premium of about $145,000. Imagine this hypothetical retiree has the same $235,000 to invest for retirement income. He can use $145,000 for the SPIA purchase while investing the remaining $90,000 in a side fund for long-term growth. After 10 years, assuming an annual return from a balanced portfolio of approximately 9.7 percent per year, the side fund would grow to the same $235,000. The side fund also has the potential to grow significantly larger if returns are higher, as would certainly be possible based on the long-term average return of a diversified investment portfolios. Additionally, options such as Registered Index Linked Annuities (RILAs) enable participation in market growth with some protection against potential extreme market loss events discussed earlier. According to the Center for Research in Security Prices, the historic average annual return of a 60 percent stock, 40 percent bond portfolio from 1961 through June 30, 2021 was about 10 percent, which would grow the hypothetical side fund in this example to over $240,000. In addition, the retiree continues receiving the $1,000 monthly payment from the annuity for life, while the bond holder would get no further income after the bonds mature and may have to reinvest the proceeds at a lower interest rate (though the value of the bonds would likely have risen in this scenario, providing a partial offset). A 70-year-old male has an 80 percent chance of living 10 years, a 63 percent chance of living 15 years, and four in 10 70-year-olds can expect to reach at least age 90, which means that most people who buy a SPIA at age 70 will be alive at age 80 and are likely to have more money and more income with a SPIA and a side fund than if they relied solely on bonds for income.

A Variable Annuity Offers a Death Benefit — Most variable annuities offer a death benefit, which guarantees that if the annuity owner dies at a time when the market value is less than the money they put into it because of market declines, the beneficiaries will get the original purchase amount, minus any withdrawals that may have made. In some cases, the beneficiaries can receive more than was invested via an enhanced death benefit, which steps up the death benefit payout based on positive performance of the investments, or a fixed percentage increase annually in the promised death benefit payout. A beneficiary must often recognize income and pay taxes on the earnings portion of the death benefit payout. The earnings enhancement death benefit can help offset a higher tax bill.

Overall, annuities are not designed as estate-planning tools. But these products do help a person protect his or her financial security and can often lead to a larger estate if an annuity is invested in a retirement portfolio.

How Are Annuity Products Developed and Sold?

In the United States, commercial annuities are issued by insurance companies. When new fixed and variable products are developed, they must be filed with the state's insurance department. Before these products can be sold, each state where they will be available must provide written approval.

Because variable annuities are considered securities as well as insurance products, when a new variable annuity is developed, a registration statement must be filed with the Securities and Exchange Commission (SEC). This statement includes a prospectus that discloses, among other things, the fees and charges associated with the annuity contract; a description of the various benefits, rights, and privileges afforded under the contract; any changes that can be made to the contract; and the risks and tax consequences associated with investing in the contract. The prospectus, which is updated annually, is a vital source of information for all contract holders and should be read thoroughly.

Insurance Company Ratings

Annuity guarantees are subject to the claims-paying ability of the issuing insurance company. It is therefore important to consider the financial soundness of a company before making a purchase. Companies are rated by one or more of the following independent industry analysts: AM Best Company, Standard & Poor's, Fitch Ratings, and Moody's Investors Services. The ratings do not apply to the underlying mutual funds, which are subject to market risk and will fluctuate with changes in market conditions. Ratings can differ somewhat among the analysts, so it is useful to check the ratings from at least two analysts.

Who Can Sell Annuities?

People who sell variable annuities need training in both securities and insurance. This training can be obtained from many sources. Some distributors provide in-house training to their registered representatives; others utilize training provided by insurance company wholesalers and independent third-party educators.

Fixed annuity sellers receive much of the same instruction as those selling variable annuities but do not need the securities training.

To legally sell annuities, individuals must first obtain a state insurance license from the state in which their office is located. A non-resident license must be obtained for all states in which out-of-state clients reside.

Since variable annuities are considered securities under federal securities laws, individuals who wish to sell them must, in addition to having an insurance license, be associated with a broker-dealer, be federally registered as a representative, and pass a Series 6 exam, or the more comprehensive Series 7 exam. In some jurisdictions, a state securities license is also required.

Where Can Annuities Be Purchased?

Some insurance companies sell their products only through a dedicated sales force (captive agents); others use agents who represent many companies and have no primary relationship (independent agents). But annuities can also be purchased from a variety of different sources, some of which may sell both fixed and variable annuities while others may market only one type.

Variable annuities can be purchased through several distribution channels, such as independent FINRA firms, wire houses, regional investment firms, captive agents, and banks. Fixed annuities are sold through these same distribution channels, yet sales are dominated by independent agents and banks. The difference in the percent of sales by distribution channel for fixed and variable annuities may be explained, at least in part, by the fact that purchasers of fixed annuities tend to be more conservative with their investments than those who buy variable annuities.

How Are Variable Annuity Commissions Determined?

Broker-dealer firms may be paid a commission by insurance companies when they sell variable annuity contracts. The amount of compensation depends upon the issuing insurer, the relationship the broker-dealer has with the insurer, the types of annuities sold, the amount of money invested in the annuity, and the way commissions are paid. Commissions can be paid in full at the time the annuity is sold, as a level commission over the life of the contract or some other period, or as a smaller amount at the time of the sale with a trail commission paid each year thereafter for a period. Both fixed and variable annuities may also be sold within managed, fee-based accounts, where the account is charged an ongoing annual fee and there is no commission paid on the sale of the annuity.

Registered sales representatives are, in turn, paid a commission when they sell an annuity contract. Commissions paid to representatives are generally less than the full amount paid to the broker-dealer and may or may not be on the same basis. Also, certain management personnel, such as branch managers, may be paid for sales made by representatives over whom they have supervisory responsibility.

In addition to commissions, the broker-dealer may receive other forms of compensation from insurance companies, such as lodging, travel, and meals at insurance company-sponsored meetings. Some broker-dealers also receive monetary and other support to conduct client and educational seminars.

Insurance companies recoup the commissions and other compensation they pay through the various fees, charges, and deductions within the annuity contract, including any sales load that may be imposed, but no one charge is specifically earmarked to pay commissions.