Evaluating Existing Variable Annuities

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Types Of Annuities

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Taxation Of Deferred Annuities: Types of Annuities

- Ways to differentiate annuities:
  - Deferred vs. Immediate
    - Before/after Annuity Starting Date
  - Fixed vs. Variable
  - Qualified vs. Non-qualified

Evaluating existing variable annuities

- Basic variable annuity questions to ask:
  - Who are the parties to the contract?
  - What are the current values?
  - What is the gain/cost basis?
  - What is the treatment of withdrawals?
  - What is the purpose of the annuity?
  - What are the costs of the annuity?
  - Will the company be able to provide for its guarantees?
  - What are the investment options?
  - Exit strategies

Evaluating existing variable annuities

- Parties to the contract
  - Owner
    - Owns the contract and has a right to make decisions about the contract
  - Annuitant
    - Measuring life of the contract
  - Insurance company
  - Beneficiary

Evaluating existing variable annuities

- Important annuity values
  - Annuity Cash Value
  - Surrender Cash Value
  - Death Benefit Value
  - Living Benefit (Rider) Value

Evaluating existing variable annuities

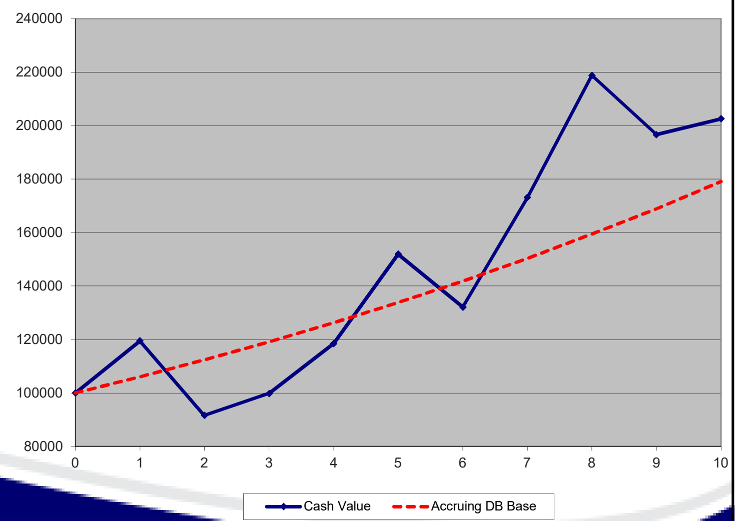
- Annuity Cash Value
  - The current value of the annuity without any adjustments or charges; this amount might NOT actually be available to walk away with!
- Surrender cash value
  - The amount of cash that would be received if the contract were surrendered today
    - May include not only surrender charges, but also other adjustments associated with the contract
    - May allow for “free withdrawal” amounts without penalty

Evaluating existing variable annuities

- Death Benefit Value
  - The amount that would be received today upon death
    - Important to know which benefit is payable upon which death
- Enhanced Death Benefit Riders
  - Base death benefit guarantee may be return of premium
  - Enhanced death benefit may:
    - Accrue original deposit at a specified percentage (e.g., 6%)
    - Pay “maximum anniversary value” high-water-mark amount
  - Enhanced death benefits often cease at a specified age (e.g., 76, 81, or 86)

Evaluating existing variable annuities

- *Enhanced Death Benefit Riders*
- Greater of 6% annually
- Actual death benefit crosses between contract value and guarantees



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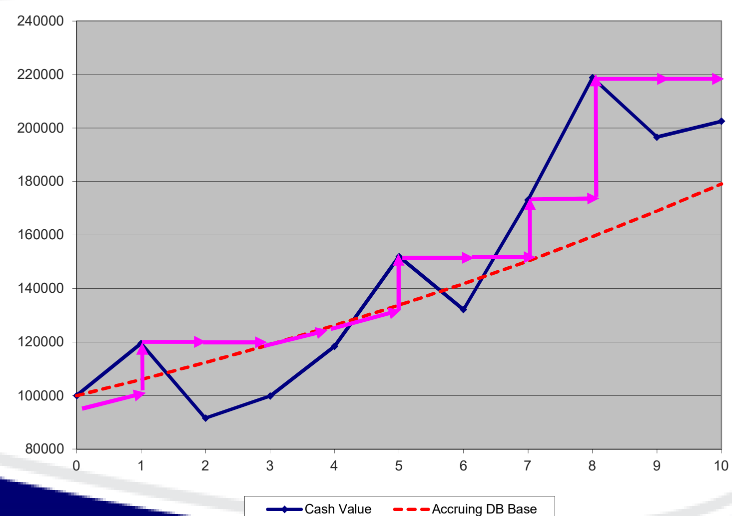
Evaluating existing variable annuities

- *Enhanced Death Benefit Riders*
- Greater of 6% annually OR maximum anniversary value
- Actual death benefit crosses between contract value and guarantees



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Evaluating existing variable annuities

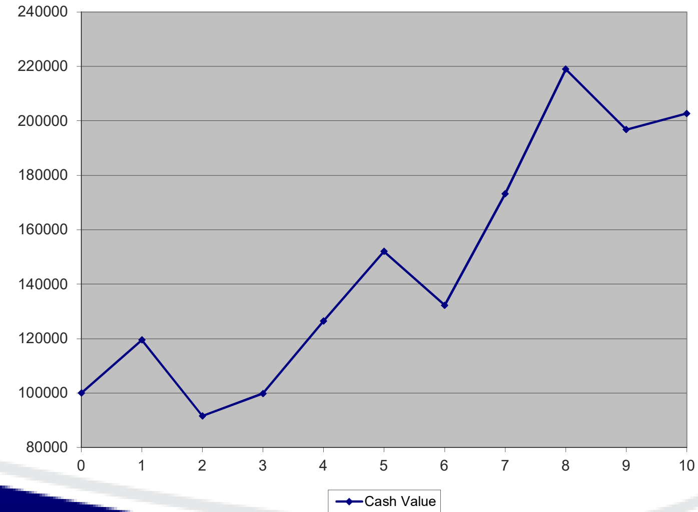
- Living Benefit Rider Value
  - Available amount associated with any applicable living benefit riders
  - Typically only applicable to VAs
  - May provide a minimum dollar amount to annuitize (GMIB rider), or a minimum withdrawal amount for a period of time (GMWB rider)

Evaluating existing variable annuities

- Guaranteed Minimum Income Benefit (GMIB)
  - Provides a “benefit base” that may be annuitized at a certain point in the future
  - Benefit base typically grows by a specified annual rate (e.g., 5%/year or 6%/year)
  - Benefit base is generally annuitized at a guaranteed (low) internal rate of return, and may have an age adjustment
  - How much can I receive as an annuitized payment, and when?

Evaluating existing variable annuities

- *Understanding Living Benefit riders…*
- Base scenario…with positive market



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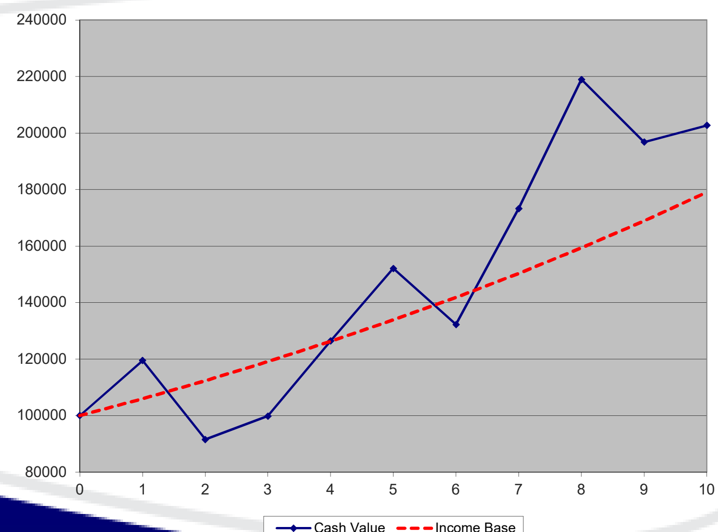
Evaluating existing variable annuities

- *Understanding Living Benefit riders…*
- **GMIB**
- - Income Base grows at 6%/year
- - Income Base provides guaranteed amount to annuitize



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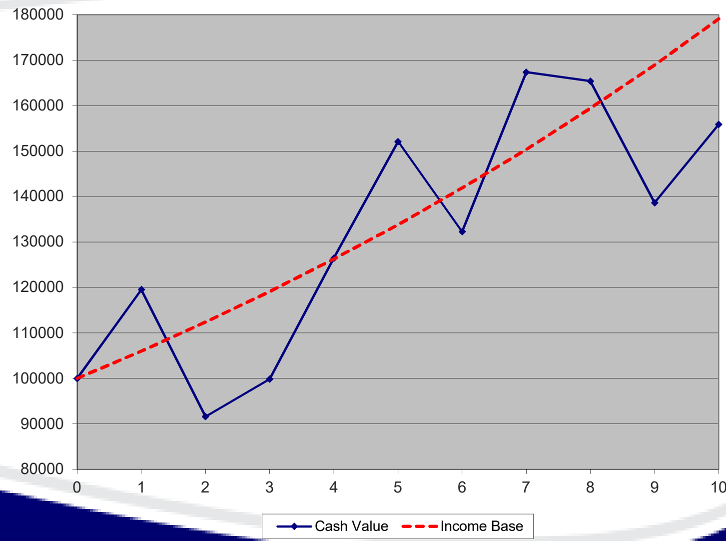
Evaluating existing variable annuities

- *Understanding Living Benefit riders…*
- **Weaker returns…**
- **GMIB**
- - Income Base grows at 6%/year
- - Income Base provides guaranteed amount to annuitize



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GMIB rider

Age	Account Value	Income Base
Start	$100,000	$100,000
60	$119,510	$106,000
61	$91,581	$112,360
62	$99,823	$119,101
…		
70	$155,864	$179,084
	Able to annuitize $179,084 over Life (w/ 10 years certain) at age 70 for ~ $12,500/year for life	

But $155,864 can be annuitized for $12,000 - $14,500/year!?

Evaluating existing variable annuities

- Guaranteed Minimum Withdrawal Benefit (GMWB)
  - Enhancement on original versions of guaranteed withdrawal benefits
  - Provides a "withdrawal base" against which withdrawals can be made guaranteed
  - *Withdrawal base may grow over time* (e.g., 5%/year) or may step up with favorable market performance
    - Guarantee may be severely impacted or entirely lost if there are additional withdrawals in excess of the maximum
  - Generally provides a guarantee of withdrawals for life *without annuitization*
  - Currently the most popular version of living benefit rider on the market; lots of variation in guarantee details from one rider to another

Evaluating existing variable annuities

- Living Benefit Rider Value
  - What is the current value/guarantee of the living benefit rider?
  - If there is a GMIB, when can the income base be annuitized, and how much income would it provide?
  - If there is a GMWB, what are the terms of the withdrawals, and is there an adjustment to the withdrawal base coming in the future?
  - What is the impact of prior or planned withdrawals on these guarantees?

Evaluating existing variable annuities

- Living Benefit Riders – Recent Trends
  - Rising cost for rider
    - Often includes opportunity to increase cost in the future
  - Limitations on portfolio allocations and/or annuity company retaining right to change allocation
  - Lower internal annuitization rates and age setback factors (for GMIBs)
  - Significant consolidation of providers; large number of companies leaving the space entirely

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Evaluating existing variable annuities

- Determining gain
  - Gain is equal to the excess of the cash value over cost basis
    - *Surrender* cash value should be used to determine gain
  - Gain can be deferred if the annuity is exchanged for another annuity
    - Consequently, cost basis *might not* be equal to the premiums paid, if the contract was acquired via a 1035 exchange!

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Evaluating existing variable annuities

- Treatment of withdrawals
  - Tax treatment of withdrawals
  - Impact on death benefits
  - Impact on living benefits
  - Value/crediting adjustments

Taxation Of Deferred Annuities: Tax Treatment During Life

- Tax-deferral
  - Only applies if owned by a natural person
  - Exception where ownership is "as an agent for a natural person"
    - Trusts as agent
    - Partnerships
    - Other entities
  - Grandfathering exception for pre-March 1, 1986 contracts
  - IRA annuities are subject to IRA rules

Taxation Of Deferred Annuities: Tax Treatment During Life

- Complete surrenders of annuities
  - Gain reported to the extent of gain

  - Deductions for deferred annuity losses
    - Allowed as an ordinary loss
    - Claimed as a miscellaneous itemized deduction subject to the 2% floor
      - Above-the-line ordinary loss claims controversial

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Taxation Of Deferred Annuities: Tax Treatment During Life

- Distributions from annuities
  - Amounts “not received as an annuity”
  - Withdrawals from post-August 13, 1982 contracts
    - Income first to the extent of gains (LIFO)
  - Withdrawals from pre-August 14, 1982 contracts
    - Principal first to the extent of pre-1982 payments (FIFO)
  - Aggregation anti-abuse rules
  - Loans, pledges, or assignments treated as immediately taxable

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Taxation Of Deferred Annuities: Tax Treatment During Life

- Distributions from annuities
  - Premature withdrawal penalties
    - 10% penalty, but applies *only* to the amount of gain reported in income
    - Exceptions to the penalty include:
      - After age 59 ½
      - Death
      - Disability
      - Substantially equal periodic payments
      - Immediately annuity where payments begin within 1 year of purchase

Taxation Of Deferred Annuities: Tax Treatment During Life

- Distributions from annuities
  - Taxation of partial withdrawals determined *without* regard to surrender charges
    - $100,000 cost basis, $105,000 cash value, $10,000 surrender charge
      - Partial withdrawal: $5,000 of ordinary income and subsequent loss recapture
  - Full surrender exception
    - Taxable only to the extent net proceeds exceed cost basis
    - $100,000 cost basis, $105,000 cash value, $10,000 surrender charge
      - Full surrender: $5,000 loss

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Evaluating existing variable annuities

- Contract adjustments at withdrawal
  - Understanding dollar-for-dollar vs. pro-rata
    - Dollar-for-dollar withdrawals reduce the benefit guarantee $1 for each $1 withdrawn
    - Pro-rata withdrawals reduce the benefit guarantee by X% for each X% of the total value withdrawn
  - Impact on living and/or death benefits

Evaluating existing variable annuities

- Contract adjustments at withdrawal

  Gain scenario
  - Contract A has $250,000 of cash value, with a $200,000 death benefit.
  - $50,000 withdrawal:
    - Dollar-for-dollar reduces death benefit to $150,000 when cash value drops to $200,000
    - Pro-rata reduces death benefit to $160,000 when cash value drops to $200,000 ($50,000 / $250,000 = 20%; $200,000 less 20% = $160,000)

Evaluating existing variable annuities

- Contract adjustments

  Gain scenario - $50,000 withdrawal

Dollar-for-Dollar			Pro-Rata		
	Account Value	Living/ Death Benefit		Account Value	Living/ Death Benefit
Year 1	$250,000	$200,000	Year 1	$250,000	$200,000
Withdrawal	$50,000	$50,000	Withdrawal	$50,000	$50,000
Adjustment	($50,000)	($50,000)	Adjustment	($50,000)	(-20%)
End balance	$200,000	$150,000	End balance	$200,000	$160,000

Evaluating existing variable annuities

- Contract adjustments at withdrawal

  Loss scenario
  - Contract A has $150,000 of cash value, with a $200,000 death benefit.
  - $50,000 withdrawal:
    - Dollar-for-dollar reduces death benefit to $150,000 when cash value drops to $100,000
    - Pro-rata reduces death benefit to $133,333 when cash value drops to $100,000 ($50,000 / $150,000 = 33%; $200,000 less 33% = $133,333)

Evaluating existing variable annuities

- Contract adjustments

  Loss scenario - $50,000 withdrawal

Dollar-for-Dollar			Pro-Rata		
	Account Value	Living/ Death Benefit		Account Value	Living/ Death Benefit
Year 1	$150,000	$200,000	Year 1	$150,000	$200,000
Withdrawal	$50,000	$50,000	Withdrawal	$50,000	$50,000
Adjustment	($50,000)	($50,000)	Adjustment	($50,000)	(-33%)
End balance	$100,000	$150,000	End balance	$100,000	$133,333

Evaluating existing variable annuities

- Contract adjustments at withdrawal

  Harvesting a Loss scenario

  – Contract C has $150,000 of cash value, with a $200,000 death benefit.

  – $148,000 withdrawal:

    - Dollar-for-dollar reduces death benefit to $52,000
    - Pro-rata reduces death benefit to $2,667

Evaluating existing variable annuities

- Contract adjustments

  Harvesting a Loss scenario - $148,000 withdrawal

Dollar-for-Dollar			Pro-Rata		
	Account Value	Living/ Death Benefit		Account Value	Living/ Death Benefit
Year 1	$150,000	$200,000	Year 1	$150,000	$200,000
Withdrawal	$148,000	$148,000	Withdrawal	$148,000	$148,000
Adjustment	($148,000)	($148,000)	Adjustment	($148,000)	(-98.67%)
End balance	$2,000	$52,000	End balance	$2,000	$2,667

Evaluating existing variable annuities

- What is the purpose of the annuity?
- Common annuity purposes
  - Annuitization income at a specific future time
  - Guarantees during withdrawal phase
  - Guaranteed future income despite market volatility
  - Guaranteed values for heirs despite market volatility
  - Aggressive investing with underlying guarantees
  - Efficient rebalancing and investment transactions
  - Post-death beneficiary restrictions
  - Creditor protection
  - Probate avoidance
  - Tax-deferred growth

Evaluating existing variable annuities

- What are the costs of the annuity?
  - Mortality and Expense (M&E) and Administrative charges
    - 60-170 bps; typical 125 bps
  - Living benefit riders
    - 50-125 bps; typical ~80 bps
    - Charged on cash value or benefit base?
  - Enhanced death benefit riders
    - 20-60 bps; typical 30 bps
    - Charged on cash value or benefit base?
  - Underlying subaccount expense ratios
    - 20-200 bps; typically analogous to mutual funds

Evaluating existing variable annuities

- Will the company be able to pay its guarantees?
- Annuity company due diligence
  - Current financial strength & ratings
  - Rating changes and trends over time
  - Is the benefit or rider still being offered? If not, why not?
- What is (and isn't) at risk if company defaults?
  - State guaranty funds & associated limits?

Evaluating existing variable annuities

- What are the investment options?
  - Consider range of available subaccounts
    - What fund families are available? Is there a sufficient diversification of asset classes?
    - *Have the options changed recently?*
  - Does the annuity provide investment models to automate investment decisions?
    - Does annuity *require* use of their investment models?
      - Increasingly common with living benefit riders

Evaluating existing variable annuities

- Exit strategies
  - Hold until death
  - Hold “for now”
  - Take one-time partial withdrawal
  - Take systematic withdrawals
  - Surrender (full withdrawal)
  - Exchange to another contract (or LTC insurance?)
  - Annuitize
  - Give annuity away (gift) – *ineffective!*

Tax Treatment At Death

Taxation Of Deferred Annuities: Tax Treatment At Death

- Contract remains in current form
  - Estate tax valuation based on cash surrender value
    - May include adjustments due to death itself
  - Post-death distributions continue to be treated as amounts not received as an annuity, unless annuitized by beneficiary
  - Rules requiring distributions from annuity after death

Taxation Of Deferred Annuities: Tax Treatment At Death

- Post-death distribution requirements
  - Annuity is *required* to begin making distributions upon the death of *any owner*
    - May force distributions while annuitant or remaining owner is alive if (different) owner has died
    - If annuity is owned by a non-natural person, primary annuitant is substituted for owner
  - Time period for required distributions will depend upon beneficiaries and annuity contract

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Taxation Of Deferred Annuities: Tax Treatment At Death

- Post-death distribution requirements
  - Default – the 5-year rule
    - Entire contract must be distributed by the 5th *anniversary date* of the owner's date of death
      - Different than retirement account rules!
  - Exceptions to the 5-year rule
    - Distributions may be made over the life expectancy of a *designated beneficiary*
    - Spousal continuation

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Taxation Of Deferred Annuities: Tax Treatment at Death

- Post-death distribution requirements
  - Payments over life expectancy
    - *Must* begin within 1 year of the owner's death
    - Requires a designated beneficiary
      - "Any *individual* designated as a beneficiary by the owner of the annuity contract"
    - Annuitization to satisfy life expectancy payments
    - Systematic withdrawals to satisfy life expectancy payments
      - Not allowed by all companies (based on PLR)
      - Payments must begin within 12 months of the decedent's date of death (non-calendar year; tax shifting possible)
      - Tax treatment allows cost basis to be allocated over the distribution period as an amount received as an annuity

Taxation Of Deferred Annuities: Tax Treatment at Death

- Post-death distribution requirements
  - Spousal continuation
    - Surviving spouse must be the beneficiary
    - Allows for the spouse to continue the contract in his/her own name
    - Contract continues 'normal' deferred annuity treatment in the name of the spouse
      - Upon death of spouse, normal rules apply based upon the death of the owner
      - Impact on living or death benefits of annuity will depend on the terms of the contract

Taxation Of Deferred Annuities: Other Issues At Death

- Other notable items
  - Income in Respect of a Decedent
    - Annuities are treated as IRD amounts
    - Post-death distributions may provide for an IRD income tax deduction
    - Be cautious of post-death assignments of benefits that trigger IRD recognition
      - Assignments from estate to estate beneficiary or trust to trust beneficiary
      - Must have ability to make non-pro rata and in-kind distributions
      - Be cautious of satisfying pecuniary bequests; cross-application of IRA-based rulings

Taxation Of Deferred Annuities: Other Issues At Death

- Other notable items
  - Step-up in basis
    - Applicable only to pre-October 21, 1979 contracts
      - Variable vs. Fixed
      - Beware of exchanging eligible contracts!
  - Post-death 1035 exchanges
    - Appears to be blessed under PLR 201330016
    - Still depends on contract-specific language

Taxation Of Deferred Annuities: Unique Complications at Death

- Trusts as beneficiaries
  - Designated beneficiary status is restricted to "individuals"
    - Trusts are not designated beneficiaries, and must follow the 5-year rule
    - Lack of "look-through" regulations; no on-point guidance
    - Parity with IRC Section 401(a)(9) (and the lack thereof)
  - Spousal continuation
    - PLR guidance for continuation with a Revocable Living Trust (RLT)
    - Potential to make post-death assignment through RLT

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Evaluating existing variable annuities

- Summary
  - Review in the context of:
    - Needs, goals, and purpose
    - Impact from current perspective, not original
  - Understand the impact of your actions:
    - Tax treatment
    - Grandfathered tax treatment
    - Effect on contract guarantees
    - Consequences of ANY kind of withdrawal

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QUESTIONS?

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