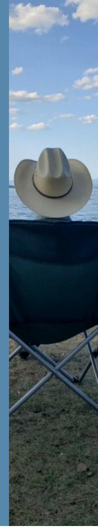
MONTANA STATE UNIVERSITY EXTENSION

MontGuide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FAMILY FINANCIAL MANAGEMENT

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Annuities

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This MontGuide describes types of annuities, contract charges, settlement options, tax consequences, shopping tips, and protections for investors provided by Montana law.

RETIREMENT… WHAT DOES IT MEAN TO YOU? Time to do what you want when you want to? More time for family and friends? Bucket-list travels? New hobbies and pursuits? A vacation home? Regardless of how you visualize your retirement years, achieving those goals won't happen overnight. Make a plan and revise it periodically based on changing situations and/or what is happening in the economy.

Many people achieve success by depositing money in different retirement savings "building blocks" such as Individual Retirement Accounts (IRAs), Keoghs, and company retirement plans (401(k), 403(b), SEPs, SIMPLES). After they have taken advantage of these to provide income to supplement Social Security, some also choose to buy an annuity outright or use retirement funds to buy one.

What is an annuity?

An annuity is a contract between an individual and an insurance company or another person. The individual pays a premium, and in return, the other party agrees to make payments to the individual during the person's lifetime and/or to the individual's survivors.

BASIC TYPES OF ANNUITIES

The most common type of annuity is called a **commercial annuity**. It is typically issued by an insurance company for a one-time payment. An individual pays a sum of money to the company (the insurer) in exchange for a promise to make periodic payments for the rest of the annuitant's life (the purchaser). Annuitants may choose to have the payments continue for a survivor's life for a higher premium. Or, for the same premium, annuitants may choose a reduced benefit so that survivor benefits can be provided.

A **private annuity** differs from a commercial annuity in two ways: 1) property other than cash is used to buy the annuity, and 2) the promise to make the payments is made by an individual rather than an insurance company. Payments from a private annuity are not insured by the Montana Life and Health Insurance Guaranty Association.

A private annuity could be used by parents who want to transfer a farm, ranch, or other business to a younger family member in exchange for a guaranteed income for life. The transferred asset receives a new income tax basis for the purchaser equal to the present value of the annuity payments to be made.

Example:
While a private annuity usually ceases upon the death of the annuitant, there are drawbacks and tax ramifications. If the parents live longer than their life expectancy, the younger family member will have paid more than the value of the asset they bought. The parents' future income flow is secured only by the annuity agreement and not by a mortgage on the property. Annuity payments made to the parents are not like mortgage payments, where the interest is tax deductible.

If the younger family member dies before the parent, the estate is legally obligated to continue to pay the annuity until the parent dies. Competent legal and accounting advice is recommended for Montanans who want to set up a private annuity to minimize potential adverse legal and tax consequences for all parties involved.

A **charitable gift annuity** is a contract between an individual and a charity (instead of an insurance company). An individual or married couple gives money or property to a charity and receives an income tax deduction at the time of the gift (donation) equal to the portion expected to go to charity when the annuitant(s) dies. The charity agrees to pay an annuity to one or more individuals and/or other annuitants(s) for their lives. Unless the charity commercially reinsures the annuity, it is backed only by the charity's total assets. There is no guarantee of payment if the charity goes bankrupt, which is why Montana law only allows charities above a certain threshold of financial strength to issue gift annuities.

Individuals considering a charitable gift annuity should have the contract examined by an attorney to make sure it meets their retirement and estate planning goals. This planned gift instrument is preferred by older individuals who want the security of a fixed income. They want the tax benefits now but do not want to benefit the charity until they pass away.

A gift annuity is also a planned gift entitling the purchaser to the **Montana Endowment Tax Credit** for the charitable gift part of the transaction if the other requirements of the credit are met. For more information, see the MSU Extension MontGuide, *Save Montana Income Taxes with a Charitable Gift Annuity: A Legacy qualifying for the Montana Endowment Tax Credit (METC)* (MT202012HR).

Categorization of annuities

Annuities are typically categorized by the timing of income payments, purchase payments, and investment performance.

TIMING OF PAYMENTS

An **immediate annuity** starts payments to an individual within 12 months of the annuity purchase date. Immediate annuities are bought by people who have reached retirement age. A **deferred annuity** starts payments more than 12 months after the purchase date, as stated in the contract or policy.

Deferred annuities are often bought by people who are saving money toward retirement. A longevity annuity pays an income for life, but only if the annuitant lives to a certain age. For example, a person could pay an insurance company a lump sum of money at age 65 for an annuity in return for a monthly income starting at age 85.

PURCHASE PAYMENTS

An annuity can be bought with a single payment or with a series of payments. An annuity purchased with a single payment is called a **single payment** or single premium annuity. Immediate annuities are always bought with a single payment. An annuity bought with a series of payments is called a **periodic payment**, multiple premium or a **flexible premium annuity**. Deferred annuities are bought with a series of payments.

INVESTMENT PERFORMANCE

There are three types of annuities categorized by investment performance: fixed, equity-indexed, and variable.

Fixed or **guaranteed annuity** provides an interest rate guaranteed by the insurance company. The amount of income paid to the annuitant is set when the payments begin and does not change. The interest rate is locked in for an initial period, typically one to three years. When the period ends, the insurance company chooses a new rate of return for the next period.

Most fixed annuities have a minimum guaranteed rate that the insurance company will pay regardless of economic conditions. However, the guarantee is only as good as the company. There is no guarantee that a fixed annuity will pay more than the rate of inflation. Because the payment is fixed, it is not likely to keep pace with inflation, especially over a lengthy period. A fixed annuity does not protect an annuitant's assets from lawsuits or seizures.

- An **equity-indexed annuity** is a variation of a fixed annuity. The interest rate is based on one of the published stock market indexes, such as the Standard & Poor's 500. The value of any index varies from day to day and is not predictable. The annuity promises to pay a minimum interest rate, but the rate of return could be higher if the stock market index increases in value. An equity-indexed annuity does not protect an annuitant's assets from lawsuits or seizures.

The National Association of Insurance Commissioners has a 19-page publication "*Buyers Guide for Deferred Annuities*" content.naic.org/sites/default/files/publication-anb-lp-consumer-annuities.pdf

The Financial Industry Regulatory Authority, Inc. (FINRA) has information about "*The Complicated Risks and Rewards of Indexed Annuities*" www.finra.org/investors/insights/complicated-risks-and-rewards-indexed-annuities

Variable annuities are securities registered with the Securities and Exchange Commission. The purchaser, rather than the insurance company, decides how to distribute the annuity premium among investments. Typically, an annuitant will select from a family of mutual funds investing in stocks, bonds, money market instruments, or a combination of the three. A variable annuity does not protect an annuitant's assets from lawsuits or seizures.

Variable annuities offer the potential to earn more than a fixed annuity, but the value of the annuity can also decrease with changes in the mutual funds' values. The guaranteed minimum return is typically 87.5 percent of the premium paid for the annuity with 1-3 percent interest.

If the value of the underlying mutual funds and the rate of return are adjusted with inflation, a variable rate annuity may provide some protection against inflation. However, there is *no guarantee* that variable annuities will keep pace with inflation.

Some variable annuities have a death benefit. If the annuitant dies before the insurer has started making payments, the beneficiary receives a specified amount – typically the amount of the annuitant's purchase payments.

When money is withdrawn from a variable annuity, the annuitant is taxed on the earnings at an ordinary income tax rate rather than at a lower capital gains rate paid on a direct investment. In general, the benefits of tax deferral outweigh the costs of a variable annuity only if it is held as a long-term investment to meet retirement and other long-range goals.

> FINRA provides an educational publication about variable annuities: *Should You Exchange Your Variable Annuity?* www.finra.org/investors/insights/exchange-variable-annuity

Charges for annuities

There are a variety of charges to be considered when buying an annuity: surrender charges, annual charges, fees and expenses, and charges for specific features.

Surrender charge. This is the amount charged if funds are withdrawn before a certain period. The surrender charge is typically a percentage of the amount withdrawn during the first 7-15 years of the annuity contract. The charge declines gradually over a period of several years, known as the surrender period. For example, a 10 percent charge could apply in the first year after a purchase of the annuity and decline by one percent per year until it reaches zero percent 10 years later.

Annual charge. This is the amount charged annually for the cost of administering the annuity contract. Annual charges may range from $25 to $40, depending on the amount in the annuity. Some companies charge a percentage of the account value (typically 0.3 percent per year).

Fees and expenses. The interest rate quoted for a fixed annuity is the amount to be paid to the annuitant after the insurance company deducts fees and expenses from the rate earned on the underlying investments. The expenses for a variable annuity are often called **mortality** and **expense risk** charges. The fees may range annually from 1-2 percent of the amount of assets in the annuity. There are also specific mutual fund fees for variable annuity contracts that include maintenance and management investment advisory fees. The management advisory fees are calculated as a percentage of the fund assets. Be sure to ask if the historical rates of returns quoted are after expenses.

Other charges. Specific features offered by some variable annuities (for example, death benefit, bonus credit, long-term care insurance) carry added fees. Other annuities have fees for initial sales load (similar to a commission an investor pays when they buy any type of security from a broker) or fees for transferring part of the account from one investment option to another. The prospectus of a variable annuity describes fees and expenses. The potential purchaser should insist on an explanation of all fees by the sales representative.

Methods of paying benefits

There are five methods of paying benefits provided in a typical annuity: (1) straight-life or lifetime-only; (2) installment-refund annuity; (3) cash-refund annuity; (4) life-and-period-certain annuity; and (5) joint-and-survivor annuity.

A **straight-life** or **lifetime-only annuity** pays the annuitant until death, regardless of whether they live to age 100 or die shortly after signing the contract. This type of annuity is usually used by people who want larger monthly incomes, who do not have dependents, or who plan to provide financial resources for their dependents in another way.

An **installment-refund annuity** provides lifetime income to the annuitant and, if the annuitant dies, pays the rest of the original investment to the beneficiary in monthly installments. This type can be used by people who want to provide a monthly income for a beneficiary rather than a lump sum payment.

A **cash-refund annuity** works like an installment-refund except the survivor receives the balance of the premiums the annuitant paid to the company in a lump sum. This choice can be used by individuals who want to ensure their beneficiaries receive a return of any remaining investment value if the annuitant dies before receiving the full value of their annuity payments.

A **life-and-period-certain annuity** pays the annuitant and a beneficiary for a specified number of years with a typical amount of time (10, 15, or 20 years). If an annuitant buys a 15-year life-and-period-certain annuity and dies after eight years, the beneficiary will receive monthly payments for the remaining seven years of the contract. This type is used by an annuitant who wants money to last for a certain number of years and wants their beneficiaries to receive the balance as an inheritance.

A **joint-and-survivor annuity** pays until both the annuitant and the beneficiary are deceased. The amount of the monthly check is based on the ages of the annuitant and the beneficiary. Joint-and-survivor contracts can pay a survivor 100 percent, 75 percent, 67 percent, or 50 percent of the monthly benefit. This type is used to provide a lifetime income to a survivor to supplement their other sources of income.

Tax consequences: income, estate, and inheritance

Income. An annuitant is not taxed annually on the interest earnings held in an annuity. Federal and state income tax on interest earning annuities is deferred until the annuitant starts receiving monthly payments; then, the earnings are taxable.

Tax-deferred contributions. Annuities meeting specific legal requirements can offer the added tax advantage of pre-tax contributions, typically termed tax-deferred annuities. Types of employer plans allowing pre-tax contributions include: 401(a), 401(k), 403(a), 403(b), and 402(b) plans; Simplified Employee Pension Plans; and 457 Deferred Compensation Plans.

The major advantage of a tax-deferred annuity is that neither contributions nor interest earned are subject to federal or state income taxation until withdrawn. This effectively lowers the gross income of the employee and reduces annual state and federal income tax liabilities like traditional Individual Retirement Accounts (IRAs).

When an employee withdraws funds from a tax-deferred annuity, the amount is subject to state and federal income taxation (see **Chart 1**). There may be an added 10 percent federal penalty for amounts withdrawn before age 59½ unless the annuitant becomes totally and permanently disabled, takes out the money in a series of equal periodic payments for the annuitant's life or the joint lives of the annuitant and their designated beneficiary, or dies.

Tax-free 1035 exchange. Annuitants can exchange an existing variable annuity contract for a new contract without paying any tax on the income and investment gains. A 1035 exchange can be useful if another annuity has better features, such as a larger death benefit, a different annuity payout, or a wider selection of investment choices. The new annuity may impose a new surrender charge period beginning when the exchange is made.

Chart 1: A comparison of the tax impact of a deductible and non-tax-deductible annuity

Tax Deferred Annuity	Non-Tax Deferred Annuity
Salary = $100,000	Salary = $100,000
Annuity Premiums: $10,000	Annuity Premiums: $10,000
Taxable Income: $90,000	Taxable Income: $100,000
Federal Income Tax Rate: 25%	Federal Income Tax Rate: 25%
Federal Income Tax: $22,500	Federal Income Tax: $25,000
Montana Income Tax Rate: 5.9%	Montana Income Tax Rate: 5.9%
Montana Income Tax: $5,310	Montana Income Tax: $5,900
Spendable Income: $62,190	Spendable Income: $59,000

An annuitant should exchange an annuity only after asking these questions and comparing benefits with an existing policy:

- What is the total cost of this exchange?
- What is the new surrender period?
- What new features are offered?
- Do I need or want these features now?
- Could a feature such as long-term care insurance be bought separately at less cost?
- Are added features worth the increased cost?
- What is the length of the free-look period?

Investors should not sign any form to agree to exchange an annuity until their options are carefully studied, questions are answered, and they are satisfied the exchange is better than their current contract.

FINRA provides an educational publication with more information about exchanging a variable annuity, *Buying and Surrendering an Annuity* (www.finra.org/investors/investing/investment-products/annuities#buying-and-surrendering).

Federal estate tax. The value of an annuity is included in a decedent's gross estate for federal estate tax purposes unless it is the type of annuity that stops payment upon the death of the annuitant. The amount to be included is based on the proportion of the purchase price contributed by the decedent and the determination of the present value of the future payments to the beneficiary using IRS annuity tables and regulations.

However, if the value of the deceased's total estate including lifetime taxable gifts and the annuity is less than $13,990,000 (in 2025, adjusted for inflation), no federal estate tax return is required to be filed (unless the decedent is survived by a spouse and the deceased spouse's unused exemption is to be allocated to the surviving spouse) and no tax is due.

The underlying mutual funds of variable annuities do not receive a "step-up" in cost basis when the owner dies, like they would if the mutual funds were bought outside the annuity. Any deferred income in the policy will be taxable to the beneficiaries as ordinary income at their tax rates.

State inheritance tax. Montana no longer has a state inheritance tax; proceeds of the annuity pass to beneficiaries' inheritance tax-free.

Probate. If an annuitant has selected a survivor benefit with a named beneficiary, the proceeds are not subject to the probate process in Montana. The annuity contract with a named beneficiary has priority, so a provision in a Will naming a different beneficiary would be invalid.

Who's selling the annuity?

Commercial annuities are only as good as the company selling them. Investigate the rating of the company before making a purchase. Major rating businesses grade insurance companies on their financial health and ability to pay claims:

- A.M. Best Company www.ambest.com
- Moody's www.moodys.com
- Standard & Poor's (S&P Global) www.spglobal.com/ratings/en
- Weiss www.weissratings.com
- Fitch www.fitchratings.com
- Annuity Association www.annuity.org/annuities/providers/ratings

The challenge for consumers is that each rating service has a different definition of financial stability and different rating codes. As an example, A++ is the top grade from A.M. Best, but second on S&P's. While a high rating does not guarantee the company will remain in business, it is one of the best indicators available for consumers to gauge an insurance company's balance sheet strength and operating performance.

Montana protections

Montana law provides protection for consumers considering the purchase of an annuity. These legal protections are enforced by the Montana Commissioner of Securities and Insurance, available online at www.csimt.gov or by calling 800-332-6148.

Licensing. The person who sells an annuity to a Montanan must be a licensed life insurance agent and, in the case of a variable annuity, also a licensed securities broker. The company selling the annuity must also be licensed in Montana. To find if an agent/dealer and company are licensed in Montana, see the FINRA BrokerCheck online at brokercheck.finra.org or call 800-289-9999. Also, contact the Montana Commissioner of Securities and Insurance at producerlicensing@mt.gov or call toll-free 800-332-6148.

Montana Life & Health Insurance Guaranty Association. If a life insurance company becomes insolvent and is ordered by a court to liquidate, the Montana Life & Health Insurance Guaranty Association provides protection for Montana residents who hold covered policies and contracts with the insolvent insurer. The limit is $250,000 per person. The coverage does not extend to any part of a policy or contract the insurer does not guarantee, such as investments in a variable annuity contract. All insurers licensed to sell annuities in the state are members of the Montana Life & Health Insurance Guaranty Association.

Montana Annuity Disclosure Act. The Montana legislature passed this Act to provide standards for the disclosure of minimum information about annuity contracts. When the application for an annuity contract is made in a face-to-face meeting, the applicant must be given a disclosure document and a buyer's guide.

When the application is taken by means other than a face-to-face meeting, such as mail, email, or the internet, the applicant must be sent the disclosure document and buyer's guide not later than five business days after the completed application is received by the insurer.

When a disclosure document and buyer's guide are not provided at or before the time of application, a free-look period of 15 days must be provided for the applicant to return the annuity contract without penalty. Many companies have a free-look period starting after the policy is physically delivered.

Items required in a disclosure document are the following:

1. Name of the contract, the company product name (if different), the form number, and the fact that it is an annuity.
2. Insurer's name and address.
3. Specific dollar amount of percentage charges and fees with an explanation of how they apply.
4. Information about the surrender guaranteed rate for new contracts containing notice the rate is subject to change.
5. Description of the contract and its benefits, emphasizing its long-term nature, including:
   - Guaranteed elements, nonguaranteed elements, and determinable elements of the contract and their limitations, if any; and an explanation of how the elements operate,
   - Explanation of the credit rate, specifying any bonus or introductory portion, the duration of the rate, and the fact that rates may change from time to time and are not guaranteed,
   - Periodic income options both on a guaranteed and nonguaranteed basis,
   - Any value reductions caused by withdrawals from or surrender of the contract,
   - How values in the contract can be accessed,
   - Death benefit, if one is available, and how it will be calculated,
   - Summary of the federal income tax status of the contract and any penalties applicable on withdrawal of values from the contract, and
   - Impact of any rider (specific features), such as long-term care.

Cautions for annuity investors

To help a person decide whether an annuity is right for their situation, the National Association of Insurance Commissioners suggests asking the following questions:

- What is a person's life expectancy? Are there any factors to indicate a person may live longer or shorter than life expectancy tables show? Life expectancy is particularly important when considering a private annuity. If a person's life expectancy is not long and they have enough assets, an annuity may not be necessary.
- How much retirement income is needed in addition to what a person will receive from Social Security, pension plan, and potential income from assets including investments?
- Is supplemental income for other family members necessary?
- How long does a person plan to leave money in the annuity?
- When are income payments needed?
- Will the annuity allow a person to gain access to the money when needed?
- What is a person's level of risk tolerance?
  - Does a person want a fixed annuity with a guaranteed interest rate and little or no risk of losing the principal?
  - Does a person want a variable annuity with the potential for higher earnings that are not guaranteed and the principal may be lost?
  - Is a person somewhere in between a fixed or variable annuity and willing to take some risks with an equity-indexed annuity?
- Did the insurance agent provide a history of the company's guaranteed renewal rates?
- Have all the tax consequences of buying an annuity been considered, including the effect of annuity payments on the buyer's tax status during retirement?

Summary

Annuities can be an effective retirement and estate planning tool for some people. Compare information for similar contracts from several companies. Comparing products and their costs may help a person make a better decision. A financial advisor can be contacted for further information about commercial and private annuities for a specific situation. A person should discuss the legal implications of private and charitable annuities with an attorney. A certified public accountant can be contacted about the tax implications of a commercial, private, or charitable annuity.

To ensure an annuity carries out a person's financial goals, the contract should be reviewed periodically as part of their estate and retirement planning process. When there is a dramatic change in a person's financial situation (divorce, death of spouse or other beneficiary, or birth of a child), plans should be reviewed.

More resources

- FINRA (Financial Industry Regulatory Authority, Inc.) www.finra.org/about
- Montana Commissioner of Securities and Insurance www.csimt.gov
- Securities and Exchange Commission www.investor.gov
- National Association of Insurance Commissioners www.naic.org
- Internal Revenue Service: Pension and Annuity Income Publication www.irs.gov/publications/p575

Acknowledgments

This publication has been reviewed by representatives of the following organizations and agencies who recommend its reading by those who are considering using an annuity as an estate planning and/or retirement tool:

- Business, Estates, Trusts, Tax and Real Property Law Section, State Bar of Montana
- National Association of Insurance and Financial Advisors (Montana Section)

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