



Deferred Fixed Annuities

Providing Safety of Principal, Tax Deferral and Higher Interest

Historical Background and Definition

The word annuity connotes some form of periodic payment. The original form of annuity was an **Immediate Life Annuity** issued by life insurance companies which guaranteed payments from an investment for the life of the annuitant. Immediate annuities also pay a guaranteed income over a fixed period of time such as fifteen or twenty years.

Insurance companies, together with enabling tax legislation, introduced the “**deferred annuity**,” an immediate annuity that starts making income payments at some distant time in the future. The deferred annuity, then, is an annuity that has the **option**, but not the requirement of taking lifetime income payments sometime in the future. The starting date for the income payments is simply deferred into the future.

Types of Deferred Annuities

Deferred Annuities are offered by life insurance companies exclusively since only life insurance companies are able to provide the option to convert to an immediate annuity that provides lifetime income. The most popular forms of deferred annuities are Fixed, Index and Variable.

Fixed Annuities are guaranteed interest instruments where the guarantee being made is made by the insurance company. This paper will deal exclusively with the fixed deferred annuity.

Index Annuities are fixed annuities where the interest credit to the account each year is credited based on the positive performance of some stock market index such as the S&P 500 index subject to a maximum amount of interest.

Variable Annuities are security products offered only with a prospectus that invest in separate accounts, mutual fund type investments.

Fixed Deferred Annuities Guarantee Interest and Principal

Fixed Deferred Annuities are typically a contract that provides a fixed interest rate guarantee for some specific term such as five to fifteen years. While there are some Fixed Deferred Annuities that provide a floating interest rate with some minimum guarantee, the most popular Fixed Deferred Annuities provide a fixed interest rate for a specific term such as five to fifteen years.

We only recommend Deferred Annuities where the outcome is determined in advance of the investment since insurance companies may reduce interest rates if they are allowed to do so.

The annuities that guarantee interest rates for a specific term are called **Multi-Year Annuities** and they are available for terms of three to fifteen years.

Deferred Fixed Annuities Provide Higher Interest Rates Than Similar Fixed Investments

Insurance companies fund these annuities by and large with high grade corporate bonds. Life Insurance companies dominate the corporate bond market and are able to assess credit quality and achieve higher yields through direct negotiation of terms. Since maturities are longer and corporate bonds pay higher interest rates than government bonds, interest rates are typically higher than similar term bank products. The insurance company claims paying ability, backs the guarantee so we advocate investing only with “**A or better**” rated insurance companies.

Tax Deferral of Investment Earnings is a Key Benefit for Non-Pension/IRA Investors of Fixed Deferred Annuities

A key feature of a **Deferred Annuity** is that all investment growth is **tax deferred** until withdrawn from the policy. This means that investors that don't need to withdraw interest are getting the benefit of the growth of what they save in income taxes as they grow their money. This tax deferral feature is already present in IRA and pension plans so these investors that buy deferred fixed annuities need to look for potentially higher interest rates and other features of the annuity. Withdrawals from the annuity are taxed on a last in first out basis as ordinary income. This means any withdrawal comes first out of the investment earnings which are taxed. When all investment earnings are withdrawn, then withdrawals come out of principal which are tax free.

For investors that are under age fifty-nine and 1/2, the investment earnings are subject to a 10% excise tax which is waived at disability, death, life annuitization, or taken as substantially equal payments payable over a life expectancy. Investors under age fifty-nine and 1/2 should not invest money they can't afford to lock up until age fifty-nine and 1/2.

Access to Your Money Before Maturity

The higher interest rates on the annuities arise from the long term bond investments made by the insurance companies. Liquidation of the annuity before maturity can be subject to a surrender charge or penalty, similar to a busted CD. Check your policy provisions. Most **Deferred Fixed Annuities** allow the penalty free withdrawal of interest monthly. This is a convenient feature for those that want the income but want to keep the principal in place. Interest can be directly deposited into your checking account to make it convenient for you. Most companies only allow you to withdraw the current interest, not the cumulative interest. Be certain to check specific policy provisions. A minority of companies allow the penalty free withdrawal of all of the investment earnings at any time.

For IRA investors, most companies permit a penalty free withdrawal of the **Required Minimum Distribution** after age seventy and 1/2 or older. This can be a larger amount than the current interest payable. This is an important consideration for those in IRA plans. Some companies

permit a penalty free withdrawal of 10% of the prior year's account value each year. This is a more attractive feature than the interest only withdrawal. However, it is usually accompanied with a lower interest rate vs. the **interest only** withdrawal plans. Withdrawals above the Interest Only, 10% or Required Minimum Distribution are subject to a surrender charge which is clearly spelled out in the policy and brochure from the company. There are, however, waivers for the penalty or surrender charge. The surrender charge is usually waived at death, disability or nursing home admittance for the annuitant owner. Each company has a slight variation in terms so it pays to look at the provisions.

Market Value Adjustments (MVA)

In additions to the surrender charge, a withdrawal or surrender of an annuity policy can incur a market value adjustment. A market value adjustment can be positive or negative. In effect, the **market value adjustment** penalizes you if the company has to cash in their bonds to pay you if interest rates have gone up since your purchase. If interest rates have gone down since your purchase, the MVA means the company sells its bonds to pay you off at a profit and they pay you the MVA which is then a profit. The presence of the MVA and surrender charges requires that the investor have some other source of liquidity.

Options at the End of the Interest Rate Guarantee Period

When the initial interest rate term is over, the insurance company will declare a new interest rate and terms for you to consider. Usually there is a thirty-day window to decide if you want that new rate. It is always sensible at that time to see what other companies are offering in rates and terms at that time. If you own the annuity in your IRA, then you don't have to keep the annuity. You can invest in any IRA eligible investment.

If you own the annuity outside of your IRA (non-qualified) and you have left the investment earnings in the policy, then you need to exchange the annuity to another annuity under **sections 1035** of the internal revenue code to avoid paying income tax on the earnings. You don't need to keep the annuity as a Fixed Deferred Annuity. Instead, you could transfer it to an Immediate Annuity or other type of annuity, if you so choose. It always pays to shop annuities at the end of the initial term as companies that were competitive when you bought, may no longer be competitive at renewal.

Annuitization Benefits

During the initial term of the **Multi-year Guarantee Annuity**, the deferred annuity can be converted to an Immediate Annuity without surrender charge at the insurance company's current rates (usually with higher benefits). This can be a good benefit for someone that needs income. While all companies waive the surrender charge, some impose a market value adjustment (MVA) which would be a problem, if interest rates have gone up since purchase

Death Benefits

Besides the waiver of penalties at death, there are other considerations for the annuity. Proceeds payable to a named beneficiary pass free of probate. A primary and secondary beneficiary other than the estate should always be named to obtain this benefit. The surviving spouse can continue the annuity in his or her name at the same insurance company or a different company to defer income taxes on the proceeds. Non spouses can elect a payout as an Immediate Annuity over life or a period certain to avoid the lump sum taxation of untaxed annuity earnings. Alternatively, they can elect a stretch annuity plan where they withdraw a life expectancy rate that is adjusted each year as they get older.

Choosing an Insurance Company and Safety of Your Money

There are a small number of insurance companies that offer **Deferred Annuities** and even fewer that are consistently competitive in the market. Rates from companies vary weekly depending on insurance company investment opportunities and current reserve levels.

Companies therefore literally come in and out of the market weekly. Company strength or credit ratings are important as well. In looking at ratings, we feel it is important to look at all of the rating agencies, not just one. A.M. Best, Standard and Poors (S&P), Moodys and Fitch are the major rating agencies that analyze the credit quality of insurance companies. We prefer to look at all of the agencies as they may have done their analysis at different times and may have opinions we should be concerned about.

The problem with using the multiple rating agencies is they all use a different rating scheme. For example, A+ is the second highest rating for A.M. Best. However, an A+ rating from S&P is the fifth highest rating. For this reason, insurance insiders use the Comdex score. The Comdex score is not a rating but a score which normalizes the different rating agency ratings and expresses them numerically.

A Comdex score of 90 for example means that the company has a stronger financial profile than 90% of all companies rated. We feel that the Comdex score pays attention to all ratings, normalizes those ratings and expresses the score in a form that has meaning. While we quote companies with low scores, we prefer companies 90 or better. Very few companies provide significantly different rates for larger annuity investments. For this reason, it may be desirable to purchase multiple policies from different companies. Moreover, each state has an insurance guarantee association that backs up your annuity benefit should a company become insolvent.

All state guarantee associations have limits on the amount of benefit they provide to each annuitant from one company. Purchasing multiple companies to stay in the limit for a state may make sense if it does not cost much in reduced overall payment.

Additional information on the state guarantee association can be obtained for each state at:
<http://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo> .

Additional information on the Comdex score can be obtained at the following two links on the internet:

<http://www.ebixlife.com/vitalsigns/comdexconfus.aspx> ,

http://www.lifelinkcorp.com/vitalsigns/comdex_ps.asp?nb=29&sb=11.