The Encyclopedia of Annuities

by Paul Renfroe
Host of the Emerald Coast Senior Show

Annuities are increasingly popular in our country. Why?

This white paper will help you the “annuity layman” by explaining in detail:

1. the original idea of annuities,
2. the role of life insurance companies,
3. annuities' legal qualities,
4. the stability of annuity issuers,
5. the types of annuities,
6. the taxation of annuities, and
7. how you can use them

We will touch upon how the companies offering annuities make money, how and why journalists can be wrong about annuities more often than right, and how capitalism creates an environment where you can get **guaranteed lifetime income**.

THE IDEA OF THE ANNUITY

Annuities today are far advanced from their simple conceptual beginnings. Annuities have been available for 200 years and modern developments have greatly improved them. Now in our time of the early 21st Century, less than 5% of annuities are used in the way that was originally the only usage.

The word “annuity” stems from the same Latin root as “annual,” and the annuity was invented over the 18th and 19th Centuries when all students were required to study Latin! (Maybe that is one reason that annuities are so mysterious to people today.) Such a name emphasizes the regular, reliable, and repetitious nature of “something.”

With an annuity, that “something”is income. **Guaranteed, repetitious, reliable income**. That's the first of several reasons that annuities are a highly valued element of a good plan at Emerald Coast Financial Accounts LLC.

So now you know the most fundamental idea that gave rise to the availability of annuities—repetitive, reliable income.

ORIGINAL DURATION OF INCOME & THE ROLE OF LIFE INSURANCE COMPANIES

But the name “annuity” doesn't tell us how long the income will last. The question of the income's **duration** has been solved by historical developments.

In English and American civilization, life insurance companies began to guarantee income that would **endure for your whole life**, originally, in exchange for your lump sum deposit.

Why life insurance companies? Because guaranteeing income for your whole life, a duration which is unknown to all but God, is only possible if it is done for *large* num-

bers of people—on a scale at which the longevity of the many is well-studied and easily quantified.

How much money should the insurance company require from you in order to guarantee you an income until you die? There is no way to know for you individually because the length of your life is unknown. But what if someone could group you with 999 people of similar characteristics?

That is exactly what life insurance companies do. They price their life insurance policies based on the longevities of a large number of people.

Here is an example. The insurance company does not know what individual man born in the 1960s will die at age 50, but it does know the rough number of them that will die at age 50 out of every 1000 men born in the 1960's. This is how a life insurance company establishes the cost of providing life insurance for all 1000 of those men age 50 born in the 1960s.

The same knowledge and expertise regarding longevity is necessary to answer the question about the duration of the guaranteed income. If it must be guaranteed for their customer's entire life, the company making that guarantee needs to do it for a lot of people. And that is what life insurance companies do. Life insurance companies are the only financial institutions that provide **guaranteed, repetitious, reliable income**.

If you the layman look at the sequence and direction of the cash flows for both life insurance and annuities, it will help you understand the difference. With typical life insurance, you pay a little bit regularly, and at the end (*your* life's end) a large amount is paid out by the insurance company. As far as the original annuities are concerned, you paid the company one lump sum of money, and the insurance company pays income to you regularly for a long time.

(That lump sum payment is no longer the only way to become an annuity owner, as you will see below in the section about Deferred Annuities.)

SOCIAL SECURITY IS A NATIONAL ANNUITY

However, the majority of people could not afford the lump sum necessary to establish a worthwhile lifetime annuity income. This problem was addressed in the Social Security legislation. Social Security, **guaranteeing reliable and repetitive income for life** for every citizen over a certain age, is an annuity! The payment for that annuity is administered by the government and funded by its collecting small amounts from every citizen's earned income throughout their working life.

Unlike the original annuity concept, however, you do not have your own account within the Social Security coffers and none of the legal qualities of an annuity are available to you.

LEGAL QUALITIES OF ANNUITIES, & THEIR REGULATION

A market developed over time for people seeking **guaranteed reliable life income** in exchange for lump sum deposits. What's to keep hucksters and scam artists from posing as income guarantors, taking people's money and failing to pay the promised income?

The states began regulating insurance companies in order to prevent this (among

other reasons). An annuity agreement came to be styled as a legal contract. If you have an annuity you can get it out and see the word "contract" in several places, and possibly on your statements from the insurance company.

As a contract, an annuity benefits you in several ways.

First, it is legally enforceable. Our legal system provides courts in which you can sue the insurance company for breach of contract.

Second, the contract cannot be changed by either of the parties to it and that includes the insurance company. This gives you, a single individual, an equal standing to a large financial institution. By contrast, institutions that offer you non-contractual assets such as mutual funds, 401k's, CDs, etc. have the right to change the terms of their service to you without your consent.

In fact, all employer-based retirement plans such as 401k's, TSAs (403b's), 457's can all be changed by other parties besides you and the financial institution.

Third, the practice of legislatures at the state and federal level is to grandfather existing annuity contracts from changes in the law and from changes in the tax structure.

This provides a valuable protection to you today, because as our nation careens toward the aging of the Boomers, it seems likely that our government will be seeking more revenue from the *haves* to pay for entitlements for all citizens.

If you had the foresight to save for retirement, you are a *have.* There may be a target on you. Using an annuity for some or all of your retirement savings provides some additional insulation from future tax law changes.

(It is this same impending swell in the ranks of the aged which threatens all your money in plans that are based on the Internal Revenue Code and subject to Congressional legislation. Again, this includes 401k's, TSAs (403b's), 457's, Roth IRAs, Traditional IRAs, and the like. For more on this, ask for our white paper entitled, "*Retirement Plans & Their Handicaps*.")

Fourth, the states' regulation of the annuity contract (and also the life insurance contract) benefits you. In order to provide insurance in a state, an insurance company must satisfy the state insurance regulators that it has the financial strength and management prudence to stand behind its contracts with citizens of that state. The regulators provide this service in the interests of the state's citizens.

ANNUITY STABILITY & THE LIFE & HEALTH GUARANTY ASSOCIATION

To enter into an annuity contract for **lifetime income** to be paid to you by an insurance company, a prudent person like you the reader would want to be sure that the company is able to fulfill its obligation to you no matter what the company's future may hold.

Sharing your interest, the state regulators require any life insurance company doing business in that state to accept a share of the financial liability of that state's Life and Health Guaranty Association.

That is a state-mandated look-alike to the FDIC (Federal Deposit Insurance Corp). The FDIC is well-known as the guarantor of bank deposits. Banks rely on their FDIC membership to reassure their depositors up to $100,000.

The state Life and Health Guaranty Association (L&HGA) guarantees your insur-

ance company's guarantees of your annuity values up to $250,000 per person per company. It is funded by contributions from life insurance companies doing business in the state, when a life insurance company becomes unable to fulfill its contractual obligations to the citizens of that state.

Please note that the L&HGA does not guarantee any values that are not guaranteed by your insurance company.

The state L&HGA is little known to the public. This may be the first you have heard of it. If you have an annuity, you can get it out and in all likelihood you will see a notice about your state's L&HGA.

Why is it so little known?

THE STABILITY OF ANNUITY ISSUERS

The L&HGA is rarely called upon to fulfill its function, compared to the FDIC. This is the main reason it is so little known.

Do you remember when the 2000 computer crash was the scare *du jour*? In prepa-ration to advise clients, I studied the Great Depression and the financial crisis which followed the 1986 Tax Reform Act.

All Americans well know the severity of the Great Depression and the magnitude of bank failures. Fully one-third of the nations banks failed from 1931 to 1934. Do you know how many life insurance companies failed during the Great Depression?

Nobody knows the answer to that. The reason is simple. Not one of them did.

What about modern times, now that bank protection agencies are established? From 1986 to 1996, banks failed at the rate of 10 yearly—not counting the Savings & Loans. During that same period, there was less than one life insurance company failure per year—equally impressive to their stability during the Great Depression.

All of which is to say, you haven't heard much about the state L&HGA because you haven't *needed* to. **Life insurance companies rarely fail.**

On the other hand, you do hear about the FDIC, and it is heavily marketed, because banks *need* it to *reassure* their large depositors. From 1983-2014, the FDIC paid out *$4.7 TRILLION* dollars to cover bank failures--218 times more than L&HGA's did.

These facts stem in part from the usage each type of institution makes of its assets. Banks put their assets into circulation in loans to a much larger degree than insurance companies. When that third of the nation's banks failed in the 1930s, they habitually kept $25 out of every $100 deposits in the vault—a 25% *liquidity ratio*. Today, banks keep an average of $5 of every $100 deposits in the vault—a 5% liquidity ratio.

Life insurance companies by contrast have between $80 and $95 of every $100 in cash and marketable securities—an 80-95% liquidity ratio. This further insulates them from market forces that harm banks.

SELF-CONTAINED DIVERSIFICATION

Diversification is a defensive concept whose sole value is the prevention of loss. Diversification has no value of its own and cannot be liquidated.

When the insurance company is investing capital, it does so in hundreds of different financial securities, more than any one person could own. To satisfy state regulators,

these investments must be exceptionally prudent. Insurance companies are a self-contained diversification program because you get everything that mutual diversification offers—protection from the risk of loss—and much more besides as you will now see.

TYPES OF ANNUITIES—WHEN THE INCOME BEGINS

Annuities are hard to understand for laymen, hard to accurately write about for journalists (financial and otherwise), and hard for insurance agents to explain.

One reason: there are more than "31 flavors," and the number of types is growing. Another explanation lies in our society's customary usages of annuities as savings accounts with superior qualities. The usage which comprised 100% of original annuities' purposes—immediate lifelong income—now characterizes only 5% of annuities today.

Confusion can also occur because annuities are differentiated in several ways. The services of a knowledgeable and experiened financial professional, such as Paul Renfroe, are critical.

We begin with the distinction of **when the guaranteed income starts**. Either it starts right after your deposit (called premium in insurance parlance), or is deferred to start at a later date, if ever. The first type is called *an immediate annuity.* Usually the income must start right when the first deposit is received by the company, and so it is called *a Single Premium Immediate Annuity.*

Annuities whose income does not start right away are called *Deferred* Annuities because the commencement of income to you is deferred to a future date. The income from these annuities will not begin until elected by you the contract owner. Meanwhile, your deposit in the annuity is growing with compounded interest in the manner stipulated by the insurance company. (That manner of interest crediting is an additional basis of differentiation among annuities to be discussed shortly.)

There are two kinds of deferred annuities whose names are self-explanatory—*Single Premium Deferred Annuities,* and *Flexible Premium Deferred Annuities.*

The Single Premium Deferred Annuity is often used by people who like CD-type annuities. It pays a fixed, predictable interest rate, and when the fixed period for that interest rate ends, you can roll into into whatever else you desire—or spend it if you wish.

Earlier we used the contrast between life insurance cash flow and annuity cash flow. The Flexible Premium Deferred Annuity has now made it possible for you to put in small amounts of money, both regularly and intermittently, of equal amounts and varying amounts, over years. It is no longer necessary to put in a large lump sum in order to be an annuity owner. Your deposits can be *flexible.*

WHEN WITHDRAWALS CAN BE MADE

You can also make flexible withdrawals in the case of deferred annuities. When an annuity is a deferred annuity, the money in it is available to you for withdrawal. You can tell the company to send you a fixed dollar amount every month, or a fixed percentage every year, or just a one-time lump sum check—or any combination thereof.

The deferred annuity works as well as it does because the insurance company makes financial investments that require a certain amount of years to perform at their fullest. Putting your money into a deferred annuity only works for you if you leave most

of it in there *to be deferred.* Because the insurance company has to unwind investments for any substantial early withdrawals, for 5 to 13 years there are surrender charges that apply to withdrawals above 10% of the account value in any one year. The insurance company generally is not trying to tie anyone down, but rather to be fair to other annuity owners whose performance also depends on the longer-term return on the insurance company's financial investments. And all charges are waived under the Compassion Clause.

There is liquidity with deferred annuities and many annuities now come with checkbooks just in case. However, you shouldn't put money into an annuity if you plan, during the first 5-13 years, on using more than 10-20% of it in any one year. After that number of years the deferred annuity is completely liquid.

Surrender charges should not prevent annuity use if there are a) no planned withdrawals for 5-13 years, b) other resources for meeting needs that may arise, and c) serious intentions to save money for your future. In the case of fixed annuities, a type to be discussed shortly, the surrender charges are the only charges you should expect to encounter. In exchange for all the guarantees you receive, the surrender charges are not onerous after the first three to five years.

DEFERRED ANNUITIES—AMOUNT OF THE FUTURE PAYMENTS

Considering that the guaranteed income will start in the future in the case of the deferred annuity, **the insurance company guarantees to you the rate of income to be paid to you at that time**. If you have an annuity, you can look in the back of it and see tables showing how many dollars per month you will be paid, depending first on the age at which you select to begin the guaranteed income, second on the total amount to which your deposits and compounded interest have grown, third on your gender, and fourth on the duration you select (more later).

Insurance companies and regulators agree on a new mortality table each 20 years, that is, the longevity expectations that underlie the guaranteed rates of income payment. At the bottom or top of the income tables in an annuity contract, you are told what year's mortality table the chart is based on.

When a new mortality table is published, insurance companies lower the rates of payment tables in the new annuities issued after that time.

However, because your existing annuity is a contract, *your* guaranteed payment rates are *not* changed. The new guaranteed payment rates only effect new contracts issued subsequent to the table change.

Because longevities in our society are increasing, having your **guaranteed future income** based on an older, existing mortality table is valuable to you. Comparisons of the 1960, 1980 and 2000 mortality tables shows that the guaranteed payment rates went *down* between 5% and 20% each time.

TYPES OF ANNUITIES—INCOME DURATION CHOICES

Earlier, the original annuities' duration for your whole life was discussed. Now there are many variations from that original lifetime guarantee.

Immediate annuities are quoted, and the contract issued, based on one specific selection of the duration choices the issuing company offers. Every *deferred* annuity has its

duration choices listed under the heading, “Settlement Options.” This name derives from the last decision you have about the annuity. At a future date and at your discretion, you (or your heirs) must decide how to take your money out of it. Subsequent to this decision, the annuity is considered “settled,” with no further decisions or alterations remaining to be made.

The granddaddy of durations or settlement options is for guaranteed lifetime income. Annuities state this as *single life only*, sometimes adding the phrase, *with no period certain.* A person who selects this option receives more income from the company for an equal deposit than those choosing other options. This option pays you the most.

There is a risk to choosing a *single life only* duration—if you select this option and die before all your money has been paid out to you, no more payments are forthcoming. The insurance company keeps the unused balance in exchange for the risk they assumed, namely, that you would live a very long time past the return of all your original deposit.

(You may remember in the 1990s that a man in France paid a woman a monthly payment so that when she died he could get her apartment in Paris. She turned out to be the world's oldest living person at that time and outlived him! He took the risk, but he did not have a large number of people to offset it.)

To offset this risk, insurance companies developed the income concept known as *single life with period certain.* You can choose income to last the longer of your lifetime or a defined period such as 5, 10 or 20 years. Because of the increase in the insurance company's risk of making years of payments, the income paid to you is less for the same deposit than would be provided by *single life only*.

Lastly, you can select a *period certain only* payment. Whether you are alive or dead, the payments will continue for that period and then come to an end.

The options offered by issuing companies will vary from company to company.

TYPES OF ANNUITIES—FREQUENCY OF PAYMENTS

The income payments to be made to you can vary in frequency. As the Latin root suggests, annual payments are one choice you can make.

Semiannual payments are available in some annuities. All offer quarterly payments and monthly payments. Monthly income payments are far more frequently chosen by our clients.

TYPES OF ANNUITIES—NUMBER OF ANNUITANTS

We have discussed the distinctions of annuities based on when income begins, on choices for the duration of income, and frequency of income payments. They also differ based on the number of annuitants, usually either one or two.

An annuitant is the person whose date of birth is used to establish the mortality table age at which income is selected to begin, and whose date of death is used to establish income termination under the *life only* duration choices. The annuitant can be a different person from the owner, and from the depositor/premium payor.

The options stated above, with the exception of *period certain*, only apply in the case of one annuitant. However, annuities may have more than one annuitant. In such a

case, the income options must account for the fact that one of the annuitants will likely outlive the other.

Thus the settlement options offered may include *joint and survivor*, so that income continues until the second death of the two annuitants and then stops. At the first death of one of the annuitants, the income continues as if both were alive, without alteration.

A similar option lowers the income by a specified ratio after the first death. These are called *joint and two-thirds survivor, joint and half survivor,* and so forth. Again, the options offered by issuing companies will vary from company to company.

These options will be familiar to anyone who has retired with a company retirement plan among their assets. Such plans are required by law to offer joint and survivor payouts. Therefore, if another option is chosen, many states require your spouse to consent to this in the presence of a notary.

TYPES OF ANNUITIES—INTEREST CREDITING METHODS

It is this set of distinctions among deferred annuities which is often written about publicly. Because annuities have been mysterious to people, annuities are naturally compared to other more familiar assets, such as mutual funds or CDs.

Interest crediting methods only apply to deferred annuities, since immediate annuities are providing the quoted payment with the interest already calculated in.

Based on the interest crediting methods, any given deferred annuity falls into one of three categories. Not all literature agrees on this nomenclature, largely because of the relatively recent development of the third type with its hybrid qualities.

THE FIXED ANNUITY

The first and original category is the *Fixed Annuity*, a term on which there is no disagreement. The term "fixed" originally denoted that the insurance company guaranteed your principal and your growth rate during deferral.

Since the development of category two, the *variable* annuity which credits growth to you based on mutual fund performance, the term "fixed annuity" is understood by many to mean, "not in mutual funds."

In fact, your funds in a fixed annuity are receiving the specified interest rate based on the financial performance of the insurance company assets. That is why you might hear it referred to as a "declared interest rate" because the insurance company is declaring what it earned (and/or knows that it will earn) and can credit to you over the coming year.

At heart the fixed annuity is so named because your *values* are "fixed," that is to say, fully guaranteed by the insurance company to perform at a minimum rate of growth. When you receive your fixed annuity contract, there is a page in the front entitled "Guaranteed Values." There you see your premium deposit listed, and what it is guaranteed to grow to over the ensuing years.

The preeminence of the insurance company's declared interest rate and account value guarantees is the universally shared characteristic of the *fixed annuity.*

It is important to realize that the guaranteed growth is not always the maximum growth rate you will receive. Many fixed annuities guarantee 3% interest as long as you

own the contract in deferral, but may actually pay more interest. Our company long had many clients earning 6.85% on such fixed annuities set up in the late 1990s.

This difference between the minimum guaranteed and what you may actually receive is also a development from the original annuities, where one rate was guaranteed to the contract owner. As financial sophistication has increased in our society, popular expectations have created a competitive environment for insurance companies to provide as much interest as they can to you.

The insurance company's financial gain from serving you is an equally simple concept. After purchasing the securities and investments with the money received for such annuities, the insurance company receives the interest payable by those securities (or gains from trading them). It keeps what it needs for profitable operation and pays the annuity owners the balance.

When the insurance company declares the interest rate they will pay the annuity owner, this calculation has been carefully done already.

THE VARIABLE ANNUITY

The second category is the *Variable Annuity.* Invented and mass-marketed in the second half of the 20th Century, the variable annuity replaced the engine of financial growth (the insurance company assets) with a new engine of growth, mutual funds.

A variable annuity credits you with growth based entirely on the performance of the mutual funds you pick to put your money in.

For investors who came up through the 1980s and 1990s, that may seem like a good idea. But think back over the history you have read about in this white paper for an added perspective.

The variable annuity did away with the minimum guaranteed performance of your annuity deposit. It could go to zero value. And the variable annuity eliminated the minimum rate of growth. It could be zero and it could be negative. In other words, the variable annuity does ***not*** have the page entitled "Guaranteed Values."

The state Life & Health Guaranty Association backing is not applicable to values that are not guaranteed by the insurance company. The absence of value guarantees in the variable annuity negates the value of the L&HGA.

Who would chose something like that? The same people buying stocks, bonds, securities of all kinds including mutual funds. People buy assets that can go to zero every second of the day!

Considering that annuities were all about guarantees for the first hundred years of their existence, to strip an annuity of all the time-tested guarantees would seem like marketing madness. Why would anybody buy something from an insurance company that had no insurance of its values?

In fact, who really stands to gain from the removal of the guarantees, but the insurance company? With the change from the fixed annuity with its guaranteed performance, to the variable annuity with its mutual fund variations, the insurance company is relieved of all but one risk in the annuity contract—the length-of-life risks addressed in the earlier section about income duration.

And as stated earlier, only 5% of annuities today are used in this way.

With this perspective on the insurance companies' motive to promote variable annuities, the question arises, what does the annuity contract structure add to the mutual funds that they did not have already?

The variable annuity adds several things that make it popular. First, you can allocate your investment in different funds, sectors, and types. You can change that allocation at will. This is obviously appealing to people who like to be in tune with the market and act accordingly.

Second, the deferred taxation of annuities, discussed below, means that you can do this mutual fund trading without tax in the year of your trade.

Third, an annuity structure adds to mutual funds the guaranteed rate of income to be paid you when you elect, anytime in your lifetime, to end deferral and begin annuity payments—something not possible with mutual funds, stocks and bonds except by using an annuity.

The guaranteed income from a variable annuity can also be tied to the performance of the selected mutual funds. When a variable annuity is turned into an income, the income is expressed as a fixed number of units per month (or period you have chosen) for life (or duration you have chosen). The value of those units fluctuates with the mutual funds valuation and so the dollar amount of your income fluctuates.

VARIABLE ANNUITIES—HOW THE INSURANCE COMPANY MAKES ITS MONEY

What does the insurance company get from offering variable annuities? The insurance company collects fees within the variable annuity for providing its services. These fees are deducted from the account values on a schedule specified in the variable annuity contract.

It is these fees which are often written about disparagingly in the press when you read, “don't use annuities because of the excessive fees.” Almost always these articles are poorly-researched, knee-jerk, sensationalizing attempts to provoke your purchase of the magazine. Don't be alarmed by them! However, it's wise to know what the fees are within your variable annuity.

Fees differ from company to company. There is an “administration fee,” which is used to reimburse the insurance company for the cost of communicating to you the contract owner.

There is a “mortality and expense fee,” which compensates the insurance company for providing the income guarantees that may be exercised in your future lifetime.

There are other fees which cover the cost of selling you the annuity. And your variable annuity may have riders that cost a fee also, such as a guaranteed death benefit.

The reader may naturally ask, “***why*** would I put my money into something from an insurance company that has no insured values, and the one guarantee left (the future income payouts) is used by only 5% of annuity owners, and on top of all that, pay the insurance company fees out of my growth for services that serve them not me, and on top of that, fees that never existed in fixed annuities?”

Because of the hope of growth offered by the mutual funds investability of your money within the annuity. It is easy to see why marketing variable annuities was so easy during the 1980s and 1990s, when their market share shot up.

With the financial debacle of 9/11 and its ensuing partners in time, Enron, Worldcom, Martha Stewart, Arthur Anderson, and the two-year double digit decline of the markets, the so-called wisdom of the variable annuity promotion has finally begun to be questioned.

For all its handicaps, the variable annuity has one strength that the original fixed annuity could not compete with—the hope of significant growth based on market growth. In the last 15 years the third, hybrid type of annuity has come to market which contains the best characteristics of both its parents.

THE FIXED EQUITY INDEX ANNUITY

If an insurance company could offer the hope of growth tied to the markets, while providing the guarantees of a fixed annuity, that would be the best of both types for the annuity contract owner. This is the *Fixed Equity Index Annuity.*

Its status as a relative newcomer among annuity growth crediting methods has resulted in the use of varying nomenclature but almost always it is at least referred to as an "equity index annuity" or "EIA." However, the word "fixed" denotes that the insurance company is guaranteeing values and is therefore quite important.

The fixed equity index annuity appeared during a time of debate about index fund investing. The last 15 years have seen the promotion of index fund investing. It is frequently observed by its proponents that no mutual fund manager has consistently outperformed the S & P 500, a broad index of the market.

The Standard and Poor's 500 Index is a proprietary index and is not available for purchase. However, they publish its calculation methods and the stocks on which its calculation is based. Mutual funds called "index funds" copy this and make their stock trades based on the published composition of the Index.

So it is believed that the average investor has a better chance for long-term growth by owning mutual funds which purchase the stocks selected for inclusion in the S&P 500 Index, or similar market index.

Another reason for index fund investing is our time shortage in society which precludes all but the full-time investor from adequately studying purchases and sales, and from quickly responding to changes in the market.

The equity index annuity capitalizes on the public's openness to index fund investing. Equity index annuities offer interest crediting based on all the major market indices, the DJIA, S&P 500, Lehman Brothers Bond Index, and so on.

Even while offering market returns, the fixed equity index annuity provides—as you would expect from the earlier explanation of a fixed annuity—guaranteed values to the annuity owner. In a fixed equity index annuity, just like in a traditional fixed annuity, you find a page near the front entitled "Guaranteed Values."

These guaranteed values are the obligation of the insurance company and thus are included in the values covered by the benefits of the state Life & Health Guaranty Association.

Like all annuities, the fixed equity index annuity also has the tables of guaranteed future rates of income.

Most exciting for owners of quality Fixed Equity Index Annuities is **the yearly**

guarantee of gains made. With such a fixed equity index annuity, when you have a gain at the end of a timetable measuring term, it becomes part of your guaranteed values and can never be lost to market risk.

This is stated in the annuity contract in sentences such as, "*in no case will the interest credited be less than zero.*" Obviously, if interest is never less than zero, then your money can never go down due to negative interest.

This guarantee of values that takes place at the end of each timetable measuring term supersedes the guaranteed values shown on the page entitled "Guaranteed Values." Thus, when you come to the end of a measuring term with growth that can never be lost, by definition that is a greater value than originally appeared on the table of Guaranteed Values for that point in time.

FIXED EQUITY INDEX ANNUITIES—HOW THE COMPANY MAKES ITS MONEY

How the insurance company makes its money is also unique to the fixed equity index annuity. While there are many variations between companies and within annuity contacts, they all turn on one theme: *the more you make, the more the insurance company makes.*

At Emerald Coast Financial Accounts LLC, the concept of **incentivizing those who hold your money** is very highly regarded.

Within fixed equity index annuities, you do not have shares, as you do with mutual funds. Your money is in the insurance company portfolio. The insurance company invests the bulk of it, between 80 and 95%, into fixed income securities and assets—which support the minimum guarantees that the company is making to you. These same investments enable the insurance company to have the approval of state regulators to sell Fixed equity Index Annuities in a given state.

The balance of the money is used to purchase index options. These have been used for years and are in the same class of securities as those used from cotton farmers to currency traders. Insurance companies, with their decades and decades of investment experience, are ideally situated to understand and expertly utilize index options.

The insurance companies' strategies for the use of their index options do vary of course. The benefit of using options is that, if the market index goes up, the company makes money for you. Even better: if the market goes down, the value of the company assets may be very little affected.

This positive potential for growth with a minimum of risk is passed onto the annuity owner. The use of options also enables the annuity funds to grow based not on the value of the stocks in the index, but the movement of the index itself.

The insurance company has two sources of revenue. The interest income payable by the fixed income securities and assets is the first. The second is the performance of the market indices used.

In your contract, the calculation method is specified for each equity index strategy. There are *three basic timetable measuring terms*, and *two basic calculations* for splitting the profits between the insurance company and the annuity owner.

The reason for this variety of calculation methods is to enable you to have a better chance of the maximum possible growth in all types of markets. It will be evident in just

a moment how that occurs.

FIXED EQUITY INDEX ANNUITIES—TIMETABLE DIFFERENCES

The questions here are, how often will you and the insurance company *check* the index performance to calculate the growth, and how often will they *allocate the growth* to you and to themselves?

The first answer is monthly movement measurement, allocated or locked in annually. Here the strategy is to take stock of the movements in the index every month. The growth is calculated by averaging these movements at the end of 12 months.

The growth credited to you after 12 months then becomes locked in and cannot be lost in a quality Fixed Equity Index Annuity.

The inverse would be true as well if the monthly results are opposite, but you would be insulated from loss because your interest credited can never be less than zero.

The second timetable is annual movement measurement, locked in annually. In this strategy, the index may go up 1,000% and down 999% in 12 months and the measured growth for that period is 1%.

Again, the growth credited to your annuity from this strategy is locked in and not diminished by down markets in future years, and you are insulated from loss because the insurance company cannot credit you less than zero interest.

The third timetable for measuring the market performance is annual movement measurement, locked in every 2,3, 5, or 7 years. The length of this term varies widely among companies offering Fixed Equity Index Annuities. However, all these offerings have one quality in common regarding this timetable strategy: the company measures the index performance annually, and after the set number of years gives you the result for what you made.

You may be allocated your share based on the highest value attained during the multi-year period. Or, the annual measurements might be averaged and credited to you. In the meantime, it is possible for no growth to show on your account statements for money in the multi-year term, until the multi-year term ends.

ANNUITIES, INSURANCE COMPANY PROFITS, & COMPETITION

First a word about profit. Capitalism won, not communism, and we are capitalists in America. Capitalism is better than communism. Companies have a right to make a profit. They are not arms of the state or the church. If the insurance companies do not offer what we want, then we will not give them what they want—our deposits and our presence in their large number of people.

This is straight out of Adam Smith's classic definition of capitalism, *The Wealth of Nations* published in 1812, a hard but worthy read.

But the profit of the insurance company is not your concern. The profit of the insurance company is not ours either at Emerald Coast Financial Accounts LLC. The insurance companies can see to their own profit and are skillful to do so..

However, our own self-interest tells us that we want them in business for a long, long time. You want them to be there for the duration of your retirement. And the insurance company cannot do that unless it makes a reasonable profit each year. The great

thing about our day and age is that competition for your annuity deposits keeps them quite competitive.

Now a word about choosing the life insurance company to provide your annuity. These days, the cutting edge of competition among the companies seeking your annuity business is their **honesty**. It's striking that we've gone full circle and after all is said and done, what is the fundamental differentiation among life insurance companies? ***honesty***.

Promotion in our society is so full of "virtual" words that can mean whatever the a) advertiser wants them to mean, and b) the listener (you, the public) wants them to mean. This applies to every promotion, but when we are talking about your relationship with a company that offers you lifetime income, you want fully truthful dealings. Not virtual words! You want your questions answered.

(Testimonials on the www.EmeraldCoastAccounts.com website will demonstrate emphatically how strongly we believe this.)

Back office service—the treatment you get once you have *become* a customer—is the key to evaluation of a company. A good company will not treat you like Microsoft, a computer manufacturer, or the cable company treats you when you call them. A good company will hire the number of people necessary, and have it in their budget, to treat you courteously and without long hold times.

We emphatically offer only the accounts of companies that realize whose money it is—***yours***—and provides you the level of service and the 100% integrity that you deserve if they want to keep your business.

FIXED EQUITY INDEX ANNUITIES—PROFIT SPLIT CALCULATION METHODS

Now down to the business of this encyclopedia. There are two methods used to split the market index profits between you and the insurance company providing you the valuable guarantees.

The first method is called *a participation rate*. The idea is that the insurance company has a percentage share in the profits. This is very simple and reasonable, since they provided you the assurance you would never lose money in the market even while having market gains.

A typical participation rate is 50%. So say the market is up 1,000% at the end of the lock-in term. You receive credit of a 500% growth on your money, and the insurance company keeps the rest. You and the company split the profits half and half.

Now you can begin to see why it was said, that the Fixed Equity Index Annuity means, the more you make, the more the insurance company makes.

The second method is a *cap*. Here, the insurance company gets none of the market growth until you have been paid 100% of it up to a percentage growth cap.

A common cap is 7%. All growth from the market index between 0% and 7% comes to you. The insurance company keeps none of that; it is all yours. Conversely, all growth above the 7% cap is theirs. You get none of it; it is all theirs.

This calculation method might be called, "The bird in hand is worth two in the bush." The likelihood of consistent growth in the 0-7% range is much much higher than the consistent likelihood of growth above 7%.

These two different calculation methods—the participation rate and the cap—can

be combined with the three different measuring timetable methods—monthly, annually, or multi-annually—to offer a wide variety of ways for you and every annuity owner to capture your share of market growth—without incurring any risk of market loss of your assets.

Companies offering Fixed Equity Index Annuities compete over who has the highest participation rate, and who has the highest caps, etc. Promotion however is not always what is seems and the only way to be sure of your selection is to work with Paul Renfroe, or someone of similar attitude and experience.

It is exciting to be alive in this time with these resources. Our longer longevity has a chance of being better funded when we can earn market returns—without threatening to erode our money with market losses.

THE MATHEMATICAL VIRTUE OF NEVER HAVING MARKET LOSS

Since the fixed equity index annuity keeps you from ever going in the hole, since you never lose money, then you never have to use big gains to break even.

How about an example? This is easy math, so follow along.

If the market goes down 20% one year, and your $100,000 becomes $80,000, then for you to break even, you have to earn $20,000 which is ***25%*** of $80,000. And that's without actually earning anything. Just to *break even* after a 20% loss, you have to have a 25% gain.

But no one really puts money in the market without planning on making something for it, right? If breaking even was satisfactory, you would make just as much in a tin can.

So suppose you wanted to gain 7% a year, putting you above $114,000 after two years. Suppose during year one you suffered that 20% loss down to $80,000. To get from $80,000 to $114,000 by the end of year two, you have to have a 43% gain in the second year!! just to hit your projected growth for the two year period. Realizing this is when many investors start thinking of themselves as losers.

Contrast this with the equity index annuity performance. At the end of year one, you haven't lost any of your $100,000. In fact, while everyone else was losing money, you held your own. Then the next year, let's suppose the market really does go up 43%! Wow! Are you sad because you only get half of it? No, not at all, because you didn't lose anything the down year, you're starting with the full $100,000 this year, and when your half of the 43% increase is applied, your $100,000 becomes $121,500—far more than Mr. Mutual Fund was aiming to have, and with a lot less worry along the way.

Let's say the market only went up 25% in year two--enough for Mr. Mutual Fund to break even. You get half of that and your $100,000 becomes $112,500—not far off from the $114,000 goal.

HOW TO KNOW WHICH TYPE YOU MIGHT LIKE BEST

Who chooses Immediate Annuities and why?

The variety here is endless. Bearing in mind that few people know of this option, at the present time very few people are choosing it. We fully expect this to change as Boomers begin to realize how important a guaranteed income really is.

For an immediate annuity with life only payments and no period certain, older people with no relatives or heirs are the predominant candidates. Precisely because they have no one to care for them, they are careful to have the guaranteed income that will enable them to address any expense situation. Such retirees have seen in their friends' lives, and know all too well, how disastrously a lump sum of savings can be lost to life's events. The **guaranteed reliable repetitive income** is a huge safety blanket for the person in this category.

People who do have heirs are far more likely to prefer life payments with a 10 year period certain. This way, none of the money is lost to their heirs, but at the same time the retiree has a **guaranteed income for life.**

Young retirees—in their 50s, 60s and early 70s—are far more likely to prefer the 5-year period certain no life payout immediate annuity. For the five years following, they have a **guaranteed monthly income.** Meanwhile they can place their remaining funds for more growth, usually with a fixed deferred annuity and often a fixed equity index annuity.

An additional, strong motive for the use of immediate annuities is their taxation—coming in the next topic.

Who chooses fixed annuities (except fixed equity index annuities) and why?

The fixed deferred annuity with a fixed, declared interest rate is the choice of someone who can tolerate very little uncertainty with their money. If you worry about your money, always evaluating the best strategy to protect it, then you would be more comfortable with the fixed annuity. If you need current income from your savings, a fixed annuity might be attractive because it provides a predictable rate of interest.

People who choose and own fixed annuities are very willing to tell you why, and very little will change their mind. They want predictability and certainty. They want to *know* what they are going to get.

Its bank-based counterpart is the Certificate of Deposit (CD) which serves the same concerns. Fixed annuities historically have paid ½ to 1% more interest rate than CDs, and the annuity interest does not have to be taxed, which is next to be addressed.

Fixed annuities are also much to be preferred where a retirement income usage for the funds is planned within 5 years.

There are also bubbles in time where a high rate of interest can be locked in for a long time and that would also make a fixed annuity attractive. We have had numerous clients earning 6% to 8% guaranteed yearly interest on annuities begun in the mid to late 1990s.

Who chooses variable annuities and why?

My first 6 years in the financial business, during the 1990s, were gung ho for variable annuities. Their promotion was prevalent and people wanted them. Now with fixed equity index annuities available, that middle ground with far less risk is preferred by most.

Many people love being in the market, and some enjoy researching it, and/or feel confident enough in their market judgments. These are the people who will use the variable annuity.

Such people also appreciate the tax-deferral available in annuities, because it

means, unlike non-annuity mutual fund holdings, that they can trade often without incurring a capital gains or income tax liability.

The strong advantages of the annuity chassis, wrapped around mutual funds, are very useful for people who want a guaranteed regularity of income but do not feel a strong need for a guaranteed predictable amount of it. A similar profile governs—people who want to be able to vary the mutual funds whose performance influences the amount of their annuity income checks. That way the check is sure to come (the annuity benefit) and they can try to make it bigger all the time (the mutual fund control).

Who is choosing variable annuities today? Many more people own variable annuities than are described above. My observation is, it seems to be because their trusted financial advisor suggested it, plain and simple. No one who owns variable annuities today is expressing the strong opinions of them that were once held, other than, "that's what my advisor thought I should do."

Who chooses fixed equity index annuities and why?

The people described under fixed annuities (desiring total predictability) and under variable annuities (desiring the thrill of the market) are on the extremes of a continuum of which most people are in the middle.

Lacking the time and the confidence to research the market on their own, most people would like to have market returns if they could have them without risk.

But the fixed declared interest rates of the traditional fixed annuity leave them feeling like they are missing out on growth they could be having. If these are the only two choices, such people generally prefer to try the mutual funds or market approach and hope for the best.

The decision for the fixed equity annuity often comes under the "Why not?" category. Indeed, why not? In exchange for some of the growth, which such a person figures they could not comfortably and consistently attain by themselves, they get market returns without the market risk of losing their money.

These are today's equivalent of the 1990s variable annuity owner—bragging in the locker room, confident of their purchase, recommending others to talk to "their financial guy."

Who chooses any kind of annuity, and why?

In this paper, we have frequently called attention by bold type the primary promise of annuities: **guaranteed, reliable, repetitious income!**

In our current tax environment, there are often motives for the use of annuities that have nothing to do with the annuity qualities and so we turn now to that.

TAXATION OF ANNUITIES

Please bear in mind that this discussion of taxation for annuities has the quality of an appendix. In an ideal world, it might be relevant but not primary.

I make this comment because the financial advice proffered by "experts" as well as journalists has a common flaw quite frequently: *they allow the tax tail to wag the happiness dog.*

Before discussing the taxation of annuities, let's get our perspective back.

How much taxes you have to pay cannot be allowed to impair your happiness. If

you aim at low taxes to be happy, your happiness is too delicate. It may be that nothing will make such a person happy.

But so much financial advice and advertising and promotion is to reduce your taxes! No wonder people forget to put happiness over tax reduction. We've been brainwashed! When accountants are regarded as a person's chief advisor, that is a warning sign that the tax tail is wagging the dog.

Believe it or not, people get so used to that little dog trot, they forget to ask themselves if this tax reduction strategy or that will make them richer or happier. They actually will spend money unwisely to reduce their taxes and come out behind.

It's crazy! So beware of marketing that plays the tax scare card!

There is a second problem with all the tax reduction hoopla. Taxes are a privilege for us to pay, as the price of American citizenship. Winston Churchill wrote in his History of The English-Speaking Peoples that taxes are a gift and grant of the people to the government. Our own American independence papers speak thus. Well, I would not try individually to withhold that gift and grant! But the fact remains, the government 'r' us!

Are there more taxes than I like? Sure! But whatever your political stance, our roads are paved, our sewage is underground and out of sight (and smell), our way of life is not under foreign attack, our commerce allows success and fairness, and we are free to speak our minds.

And that is just a short list that is evident after a trip to the Third World. If that is worth fighting and dying for, then it is worth paying taxes for. I know you agree.

On the other hand, we have the right to avoid taxes as permitted and annuities have a very useful part in that. The foundation of annuity taxation is the immediate annuity—the **guaranteed reliable, repetitious income.**

The best way to help you understand annuity taxes is an example.

Let's say you give the insurance company $100,000 non-IRA money in exchange for a contractually guaranteed income of $2,000 per month for life, and you are a man age 80. Well, that's pretty good in your favor—the life expectancy for you is age 84, so if you just fall in the average and live four more years, you will get $2,000 a month for 48 months and just about break even. Then if you live longer it's all gravy. That is a good, secure plan and you no longer have to worry about losing that $100,000 somehow.

How should you be taxed? After all, the $2,000 per month has got to be some of your money coming back to you, right? You shouldn't have to pay tax on that, right? You should only have to pay tax on the income that derives from interest being paid to you, right?

Right! For once, you and the Congress agree about what should be taxable. But how much is the principal coming back to you, and how much of each month is taxable interest? Well, that can't be known until you die and the exact number of payments is known, right?

To solve for this unknown ratio of principal to interest in each annuity payment, the Congress has provided for *exclusion ratio taxation*. This simply establishes arbitrarily that if you begin an income at age 80, and you are a man, and your longevity is 84, then 43.86% is return of principal and *excluded from taxes*—hence the name “exclusion ratio.”

The beauty of this is that it creates an effective 3-5% income tax bracket for se-

niors. Think about it. Here you are, age 80, receiving $2,000 monthly, and your exclusion ratio is 43.86%. So you have $24,000 annuity income but only 13,473 of it is taxable. Say you have $12,000 annual Social Security income, You are in the 15% bracket, none of your Social Security income is taxable, you have 6,000 in standard deductions, and thus your total tax on your total gross $36,000 annual income is only $2,020 ! (13,473 taxable times 15% tax rate).

$2,020 in taxes is 5.6% effective tax rate. That is good feeling to get that low.

And that isn't all. If you had left that $100,000 at interest, earning say 5%, you would have only $5,000 of income. So you are miles ahead with annuity income plus the income is **guaranteed!**

Plus, if you had had that $24,000 of income without the benefit of being delivered by means of annuity income, you would have triggered a tax on your Social Security benefits also.

The upshot is, because your taxes are lower, you the retiree have much more income that stays in your own pocket. Unlike the tax deductions that require an expenditure, such as mortgage interest or charitable giving, this tax reduction is achieved simply by the *way you receive your income*.

Now with this understanding of *exclusion ratio taxation,* let's consider the taxation of deferred annuities. It is much simpler.

In layman's terms, annuity interest and growth is not taxable until the year you withdraw it from the annuity. Period.

When you withdraw it from the deferred annuity (and all of the annuities used by Emerald Coast Financial Accounts LLC provide easy withdrawals, for easy access to your funds if desired) you pay income tax on it. Whether you take it in a lump sum, or small lump sums, of regular monthly interest withdrawals, you only pay tax on what you take out, in the year that you take it out.

If you exercise one of the settlement options on a deferred annuity, then it is taxed just like the immediate annuity, under the exclusion ratio.

Having this means of controlling when you pay your tax is invaluable. To the degree that other income is under your control, you can plan to take your annuity income in years that the lowest tax brackets available to you.

AN ORDINARY ANNUITY STRATEGY FOR LIFE INCOME

A client of ours at age 89 had $170,000 invested in bonds and mortgage securities. On the total she was only earning 5%, or $8,500 per year. This gave her a total income of $1,300 monthly, including her Social Security of $600 month. Her assets were also creating taxes with the State of Tennessee as well as OID taxes.

Her main concern was that area nursing home bills were running at $3,000 per month and she did not have enough if she needed to enter a nursing home.

She liked the idea of putting all $170,000 into Single Premium Immediate Annuities with a life and 10 year certain payout. Her income jumped to $3,100 per month, so she was now set for the nursing home if need be.

Her tax went to zero dollars for the next 10 years.

She also had a guaranteed income of $3,100 that she could never outlive. Her

peace of mind went way up.

Meanwhile, she discovered that at her age and with her interests, she could not spend her $3,100 per month and so whenever it built up in the bank to $100,000, she would skim off $50,000 and invest it elsewhere. Investing it has been fun for her, and has helped keep her sharp mentally and engaged with the world around her.

Today, 11 years later, she is worth over $500,000. She is in the nursing home and her bill is twice what she originally feared--$6,100 per month. Her assets and guaranteed monthly income are paying for the nursing home each month via direct deposit, and she has enough for at least another 20 years, to age 120, and beyond!

And she still keeps up with her income and investments in her ledger book, balances her own checkbook, and enjoys investing. This is happiness for her.

AN ADVANCED STRATEGY—USE OF ANNUITY TO LOWER DEATH TAXES

This example is just for fun, to show how far-reaching the benefits of an annuity-based strategy can be.

Let's take a husband and wife who die with $2,000,000 in assets subject to death tax. Such people often have securities, stocks and bonds that pay them a fully taxable income at an average rate of interest, 4-6%, which in this example would be $100,000 per year. With Social Security, their tax bracket would be 25%. Say their taxes come out to $25,000 for simplicity's sake, and they are left with $75,000 yearly. At death, they leave their $2,000,000 subject to a hefty federal estate tax and the probate process which is complicated and difficult for stocks and bonds and mutual funds. This is not a desirable situation!

What if those values were put into a joint and survivor life annuity with no period certain? That would be crazy? Let's see.

$2,000,000 for a couple age 75 could generate about $14,000 monthly income, or $168,000 per year, to last until the death of the second of them. So far, they are $68,000 a year ahead of the income they were having.

Their exclusion ratio is 72.15%, meaning that $168,000 times 72% is not taxed. Their taxable income therefore is only 63,840. Even though still touching the 25% tax bracket, their tax now is only $15,960, assuming for simplicity they pay 25% on all their income.

In short, they lowered their tax bill $9,000 and increased their income at the same time by $68,000 for a total positive swing of $77,000 per year.

Wait a minute though. The heirs are certainly not going to like this plan, since the income stops when the folks die. Here is where you can get the life insurance company on the hook both coming and going.

With the extra monthly income of $77,000, purchase a life insurance policy on the folks. With proper structuring, it will pass to the heirs free of income tax and estate tax and within one month of the death certificate. The estate tax that would have been due on assets above the $2,000,000 is wiped out so that money stays in the family.

There will be no probate on it, contrary to the previous $2,000,000 of assets which could have created much headache and delay.

At these folks' age, it will have to be a cash value policy so that if funds are need-

ed, the $77,000 premium has been creating cash value and therefore is not lost.

Best of all—everyone is now rewarded if the folks take care of themselves and their health. The longer they live, the longer they receive the $168,000 income, the more the life insurance benefits grow, the more the heirs receive after their death, the smaller the tax bill, and the smarter everyone feels for having won at the financial endgame!

CONCLUSION

It would be unfair to allow you the reader to think we have tapped into all the intricacies of annuities. American ingenuity has shown itself in this area just as in manufacturing and democracy! The last example is merely one of many that could have been used.

However, if you the reader have come this far—you know more about annuities that 80% of all the insurance company agents who often sell them, and 100% of the journalists who write about them.

To contact Mr. Renfroe, visit **www.EmeraldCoastAccounts.com**.

Check out the other self-education papers, *Retirement Plans and Their Handicaps*, and *Are YOU Relying on Weak Sources for Retirement Information?* Let us know how you like this one!