ANNUITY TRAINING COURSE

8-HOUR COURSE
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Chapter 1

Historical Development of Annuity Contracts

EVOLUTION OF ANNUITIES

While many people believe annuities are a relatively new phenomenon, they’ve actually been around for centuries. The earliest annuity contracts were negotiated in ancient Roman times; annua required an up-front payment in exchange for an annual income that lasted for a fixed period, sometimes for life. These annua were first offered by speculators who dealt in marine and other lines of insurance. Domitius Ulpianus (born 170, died 228), a roman jurist, is credited with compiling the first known recorded life table for computing the estate value of annuities.

The precursor to the single premium life annuity and the deferred annuity was developed in the 1600s in France by a Neapolitan banker named Lorenzo Tonti. Tonti raised money by creating special annuity pools called *tontines*. (They were actually part annuity and part gambling venture.) Individuals who invested in the *tontines* received life annuities in exchange for an initial lump-sum payment. As annuitants died, the payout amounts to the survivors increased each year. *Tontines* were eventually outlawed because the sole survivor of the annuity pool would eventually wind up receiving all the money—an attractive incentive for survivors to kill off their partners in the *tontine*.

Many European countries, including Great Britain, used *tontines* as fundraisers for their war efforts during the 1700s. Parliament enacted many laws permitting the sale of annuities to fund wars, provide an income to the royal family, and to reward those loyal to the royal family. Great Britain and Holland also sold annuities instead of government bonds during the 1700s; their governments increased their financial resources in return for a promise of a lifetime income to those investing in the annuities. In the 1700s and 1800s, annuities became very popular in European high society because they protected annuitants from the “fall from grace” that occurred with investors in other markets.

Initially, annuities were sold at a fixed price, with no consideration given to the age or gender of the purchaser. When, after time, it became evident that the mortality rates for annuitants were less than those for the general population, a more appropriate pricing framework was devised.

The Corporation for the Relief of Poor and Distressed Presbyterian Ministers and Distressed Widows and Children of Ministers was the first insurance company to sell an annuity in the United States. The company was chartered in 1759 in Pennsylvania and provided survivorship annuities, on a group basis, for the families of Presbyterian Ministers. The first individual annuity to be sold to the public in the United States was offered in 1912 by The Pennsylvania Company for Insurance on Lives and Granting
Annuities. It offered both life insurance policies and annuities and is considered the precursor to today’s stock insurance companies.

From then on, annuity sales experienced steady growth—with a marked increase in popularity in the 1930s. During the Great Depression, insurance companies were viewed as being more stable than other financial institutions and consumers were encouraged to purchase annuities from them because of their fears about the health of other financial markets. Franklin D. Roosevelt’s New Deal Program encouraged individuals to save for their own retirement as part of his bid for Relief (to the unemployed), Reform (of business and financial practices), and Recovery (of the economy). Around the same time, group annuities for corporate pension plans began flourishing, which advanced the popularity of annuities.

These initial annuities contracts were not the complex vehicles we see today. They contained a guaranteed return of principal, paid a fixed rate of interest during the accumulation period, and offered two payout options: a fixed income for life or payments for a set number of years. Riders, options, and enhancements did not exist at that time. The tax-deferred growth of principal in the annuity, however, was a very attractive element, even then.

In 1952, the first variable annuity was created for use in college and university qualified retirement plans. Instead of crediting interest at a fixed rate, it credited interest based on the performance of separate investment accounts within the annuity. The annuity contract owner was able to choose the type of accounts in which to invest, and often received some guarantees from the insurance company in exchange for the assumption of some risks.

In 1959, the Securities and Exchange Commission (SEC) ruled that variable annuities were subject to federal securities regulation. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) permitted annuities to maintain their valuable tax-deferred status. It also allowed them to retain the exclusion ratio that treats annuitization payments as a partial return of principal and partial return of taxable earnings and changed the taxation of withdrawals from principal first to income first--First In, First Out (FIFO) to Last In, First Out (LIFO).

The National Association for Variable Annuities (NAVA) was formed in 1991 and became the Insured Retirement Institute (IRI) in 2009. Indexed annuities were introduced in 1995, bonus variable annuities were introduced in 1998, and the Pension Protection Act of 2006 overhauled the federal pension plan and tax laws. The Pension Protection Act allowed annuities to include long-term care riders, along with establishing other provisions.

Since the early days of annuities, many features have been added to annuity contracts. Some provide checkbook access to funds, enhanced “bonus” rates of interest, shorter maturity periods, and guaranteed death benefits if the annuitant dies before the annuitization period begins. The variable accounts in annuities, including mutual funds,
have significantly contributed to their increasing popularity.

Annuities often play an important role in many diversified investment portfolios. The biggest factor contributing to their appeal is, and has always been, that they offer a lifetime income—a guarantee no other investment offers. With life expectancies increasing and the uncertainty of the stock market, the guaranteed returns of annuities are looking much more interesting to today’s investors. Although the return in variable annuities is tied to the stock market and/or their underlying accounts, some guarantees present investors with a shield they’re not able to find in other financial products.

Annuities have evolved over time. More contract types, more investment options, and more guarantees now allow investors to match their investment and income goals. Guaranteed interest rates can last for the lifetime of the contract or may apply only for the first year or two. Guaranteed return of principal to the beneficiary is now an option if the annuitant dies or if annuity stock market investments decrease in value.

There is a price to be paid for the evolution of annuities and their many enhancements. The proliferation of unsuitable sales practices has prompted legislation in California and most other states to protect consumers. Because the types of annuities continue changing to meet the needs of the consumer—and because the options, features, benefits, riders, and other terms are so numerous—the average consumer is not equipped to understand them. He places his trust in the professional recommending and selling the product and, sometimes, his trust is misplaced.

MARKET OVERVIEW

According to IRI, variable annuity sales fell 15% in 2008—from $182.2 billion in 2007. IRI credits this decrease to depressed activity in the second half of the year along with financial losses and continued uncertainty in the stock market. Total variable annuity assets shrank by 24.1% between the end of 2007 and the end of 2008. The shrinkage was largely driven by the huge drop in domestic equities in the second half of 2008, which can be confirmed by the 37% negative change in the S & P 500 Total Return index.

Regulatory attention on variable products of all types continues to affect the sale of variable annuities. The Financial Industry Regulatory Authority (FINRA) continues to increase its scrutiny on the sales practices and market conduct of those selling variable annuities. The industry condemns the improper sale of its products and supports strong consumer protection legislation, regulation, and enforcement against those who violate the law.

Because of continued industry consolidation, the number of insurance companies selling variable annuities dropped in 2008—for the seventh year in a row. The number of distinctive products offered, however, increased from 359 in 1999 to 1,491 in 2008. Sales by distribution channel remained virtually unchanged in 2008, with the most popular sellers of variable annuities being captive agencies and independent FINRA firms.
IRI has this outlook for the sale of variable annuities in the future: “The use of variable annuities for securing a portion of retirement income should significantly grow the pie in the next few years as baby boomers look for ways to maximize income from shrunken nest eggs while being mindful of future inflationary pressures... The variable annuity industry is well positioned to capitalize on baby boomer demographics, the question is simply whether compelling benefits can be offered with manageable risk profiles; clearly the industry can accomplish this, and the message of “growth potential with guarantees” should resonate in this market and economic environment.”

Fixed annuity sales, according to IRI, increased by 50% in 2008, reaching a record $109.3 billion. The competitive interest rates being offered, when compared with the equity market losses and volatility experienced in 2008, had a huge appeal to consumers preferring retirement vehicles providing safety and guarantees. Fixed annuity sales peaked in 2002, during which the U.S. experienced a down market similar to the one in 2008. Between 2002 and 2008, fixed annuity sales continued to decline. Fixed annuities accounted for more than 51% of the total annuity market share in the fourth quarter of 2008—up from 27% in the first quarter of 2007. For the first time since 1995, fixed annuity sales exceeded those of variable annuity sales in the fourth quarter of 2008.

The major sales growth of fixed annuities in 2008 resulted from book value and market value adjusted annuity sales—which increased 86% and 123% respectively. Sales by distribution channel continued to be controlled by independent agents and banks, which are responsible for almost two-thirds of all fixed annuity sales.

IRI’s outlook for fixed annuity sales in the future is: “We expect to see continued success with fixed annuities, particularly if the yield curve remains positive, which provides a favorable interest rate environment for fixed deferred book value and MVA sales. The concern about protecting principal and fixed return will remain an important consideration in investor’s mind. However, the concern about the financial strength as well as better use of capital elsewhere may force many insurance companies to participate cautiously in the fixed annuity market.”

Here are some annuity sales and asset figures from IRI’s 2009 Annuity Fact Book:

- 1995 – Annuity industry sales topped $100 billion
- 1997 – Total annuity assets topped $1 trillion
- 1999 – Variable annuity sales topped $100 billion
- 2000 – Variable annuity assets topped $1 trillion
- 2002 – Fixed annuity sales topped $100 billion
- 2005 – Indexed annuity sales topped $25 billion
- 2007 – Total annuity assets topped $2 trillion

**DEMOGRAPHICS OF A TYPICAL ANNUITY OWNER**

<table>
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<th>IRI statistics indicate the following demographics of the typical owner of an annuity:</th>
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<tr>
<td>• Gender</td>
</tr>
<tr>
<td>o Female – 58%</td>
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• Level of Education
  o High school graduate – 27%
  o College graduate – 21%
  o Some college – 20%
  o Post-grad work/degree – 22%
  o Trade/tech/vocational training – 5%
  o Less than high school education – 4%

• Age
  o Average Age – 70
  o First purchase of annuity – under age 50
    ▪ Non-qualified variable annuity – 41%
    ▪ Non-qualified fixed annuity – 32%
  o First purchase of annuity – age 65+
    ▪ Non-qualified variable annuity – 17%
    ▪ Non-qualified fixed annuity – 28%

• Employment Status
  o Retired – 69%
  o Employed full-time – 15%
  o Employed part-time – 8%
  o Homemaker – 3%
  o Other – 4%

• Occupation
  o Professional – 31%
  o Blue collar/office worker – 17%
  o Support staff – 14%
  o Supervisory – 12%
  o Business owner/corporate officer – 11%
  o Other – 7%
  o Sales – 5%
  o Farmer – 2%
  o Never worked – 1%

• Annual Household Income
  o $200,000 + - 4%
  o $100,000 - $199,000 – 16%
  o $75,000 - $99,000 – 16%
  o $50,000 - $74,999 – 22%
  o $40,000 – $49,999 – 15%
  o $20,000 - $39,999 – 20%
  o Under $20,000 – 7%

• Intended Use of Annuity
  o Financial cushion in case living beyond life expectancy – 83%
  o Financial resource to avoid being a financial burden on children – 81%
  o Retirement income – 76%
  o Emergency fund for catastrophic illness or nursing home care – 73%
  o Financial protection for poor performance of other investments – 71%
• Largest Source of Retirement Income for Retired Annuity Owners
  o Social Security – 58%
  o Employer contributions to retirement plan – 48%
  o Annuity owner contributions to retirement plan – 25%
  o Personal savings or other investments – 26%
  o Full or part-time employment – 8%
  o Sale of home, farm, or business – 10%
  o Support from children or family members – 1%

• Savings in Other Financial Product
  o IRA – 71%
  o Mutual Funds – 60%
  o Certificates of Deposit – 58%
  o Cash value life insurance – 54%
  o Individual stocks or bonds – 52%
CHAPTER 1 – REVIEW QUESTIONS

Answers are in the back of the text

1. Initially, annuities were sold at a fixed price, with no consideration given to _____.
   [a] Type of annuity
   [b] Age or gender
   [c] Accumulation period
   [d] Mortality tables

2. Regulatory attention is currently focused on _____.
   [a] The SEC
   [b] TEFRA
   [c] Fixed annuities
   [d] Variable annuities

3. The typical annuity owner is _____.
   [a] Male
   [b] Female
   [c] A married couple
   [d] A group of Presbyterian ministers
Chapter 2

The Primary Uses of Annuities

ANNUITIES DEFINED

An annuity is a life insurance product that—in exchange for a sum of money paid by an individual to the insurance company, in either a lump sum or over time—liquidates the principal sum and distributes it back to the individual in the form of periodic payments. The payments begin at a specific time and may be made over the lifetime of the individual, for a certain length of time, or for a particular amount.

For example, an individual (called an annuitant) gives an insurance company $100,000 when he is fifty-eight years old—this is considered a lump sum premium deposit. In exchange for the lump sum, the insurance company issues an annuity contract and the lump sum (or principal) begins accumulating interest, per the terms of the annuity contract. At some point in the future, the annuitant will request annuitization of the contract, meaning he’ll want the insurance company to return his principal and the earned interest in the form of regular, periodic payments.

Another example involves a forty year-old individual who doesn’t have a lump sum of money with which to purchase an annuity. He may purchase an annuity, however, by making payments to the insurance company (called flexible payments) on a recurring basis, i.e. monthly, quarterly, semi-annually, or annually. Some annuities allow sporadic premium payments. Let’s say this fellow makes annual payments of $2,000 into his annuity. After the first payment, the insurance company will issue an annuity contract and the $2,000 (the principal) will begin accumulating interest, per the terms of the annuity contract. By the time he’s sixty-five years old, he’ll have made payments of $50,000. This $50,000 is his principal, just as the fifty-eight year old’s $100,000 was the principal amount of his annuity. The forty year-old fellow will request annuitization of his contract at some point, and the insurance company will make distributions, in the same fashion discussed above.

A third example involves a seventy year-old woman who purchases an annuity with a lump sum deposit of $300,000. She decides that she wants the insurance company to begin distribution of her principal immediately—in the form of monthly payments. The insurance company begins distribution of the lump sum, and credits interest on the remaining principal balance per the contract.

These basic scenarios illustrate only a fraction of the ways annuities can be used, although all three examples include the basic components:

1. The exchange of money for
2. A future stream of income
USES OF ANNUITIES

People purchase annuities for a variety of reasons. According to the Insured Retirement Institute (IRI) and the Gallup Organization, the vast majority of annuity owners purchased their contracts in 2009 because of tax-treatment, guarantees, safety of the annuity product, and good investment return. Other reasons for making annuity purchases include the guarantee of providing continuing income to a surviving spouse, the provision of an emergency fund for old age, setting aside money to pay for nursing home or catastrophic illness, avoidance of becoming a financial burden on children and other family members, and saving for education.

Investment experts routinely advise clients to diversify their investments among a number of asset classes to obtain the best return for a given level of risk. Certain types of fixed annuities help achieve this goal. Investment experts also suggest that when investments in various asset classes vary too much from the percentage allocations desired by the client, that the client “rebalance” to the original formula by shifting funds. Utilizing mutual funds for this process generates capital gains taxes; utilizing annuities avoids the capital gains tax although it does incur taxation as ordinary income when funds are withdrawn—which could occur many years after the rebalancing.

Some individuals purchase annuities to protect assets from creditors. Once a lump sum deposit is made into an annuity, the funds belong to the insurance company and no longer belong to the individual. Usually, creditors can only gain access to the payments from an annuity as they’re made. (Some states and court decisions allow for the protection from creditors of some or all annuity payments.)

IRI and Gallup also agree that the majority of annuity owners plan to use their annuity assets to fund retirement. With the extension of life expectancy, many people fear that their other investments and retirement programs will run out before they die.

OTHER RETIREMENT VEHICLES

Annuities are the only investment or retirement vehicles available, other than Social Security and pension plans, that guarantee a lifetime income during retirement. In addition to providing their owners with the security of knowing they can’t outlive their assets, annuities also provide an opportunity to increase current income.

Many retirees are faced with the challenge of finding the right balance between withdrawing enough money from retirement funds to live on comfortably while also leaving enough money in those funds for future needs. As a retiree ages, the risk of depleting retirement funds significantly increases. Annuities help reduce the risk in two important ways: they lessen the risk of running out of money and increase the amount of each payment received.

Like Social Security and pension plans, annuities utilize risk pooling (or cross-subsidy or the law of large numbers)—which allows for annuity payments that reflect the fact that
some annuitants will not live as long as others do. Because each annuitant will experience a different life span, annuity payouts are based on the average age of annuitants receiving periodic payments; effectively, annuitants dying earlier support those who live longer. Because of this feature, insurance companies are able to make annuity payments in amounts that exceed those that might otherwise be possible from a plan utilizing systematic withdrawals from a sum of money deposited into an account that gives a reasonable assurance that the funds will not be exhausted.

Retirees are depending upon Social Security and employer-provided defined benefit pension plans far less than in years past. Between a lack of confidence in the Social Security system and the decreasing number of employers who provide employee benefits of any type, consumers are focusing more and more on self-directed plans—such as 401(k)s and 403(b)s (Tax Sheltered Annuities)—and their own individual plans and investments.

In spite of the changing retirement landscape, many consumers are still unaware of the numerous retirement options available. Their understanding, not only of the variety of options available to them but also of the advantages and disadvantages of each, is an essential element of an effective retirement plan. As producers, we need to be aware of all our clients’ options—even those that do not involve insurance or annuities—in order to help them make the most appropriate decisions for their retirement planning.

**INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)**

An Individual Retirement Account (also called Individual Retirement Arrangement or Individual Retirement Annuity) is a tax-deferred retirement account that is usually established through a bank, mutual fund company, brokerage firm (for accounts), or life insurance company (for annuities). Individuals with IRAs are subject to certain contribution limits each calendar year. For example, in 2009, individuals under the age of 50 could usually contribute up to $5,000, individuals aged 50, and older could contribute $6,000. Earnings on the contributions grow tax-deferred until they are withdrawn, at which time they are taxed as ordinary income. Withdrawals made before the holder of the account is age 59 ½ incur a 10% federal tax penalty—unless the account holder meets certain exceptions, which include withdrawals made:

- On account of the IRA owner’s death
- On account of the IRA owner’s disability
- On account of the IRA owner’s qualified first-time home purchase
- On account of the IRA owner’s substantially equal periodic payments over life expectancy
- Not in excess of the IRA owner’s qualified higher education expenses
- Not in excess of the IRA owner’s certain medical insurance premiums paid while unemployed

The most common types of IRAs are classified as Traditional or Roth. Other types of IRAs include:

- SEP (Simplified Employee Pension plan) for the self-employed and small
business owners

- SIMPLE (Savings Incentive Match Plan for Employees) for businesses with 100 or fewer employees
- KEOGH for self-employed individuals or unincorporated businesses

Basic features of each include:

**Traditiona**l

- Contributions are made by the individual account holder and are tax-deductible
- Account holder must have earned income
- Account holder must NOT participate in an employer-sponsored retirement plan OR does participate in an employer-sponsored retirement plan and meets certain income requirements
- Distributions are taxed as ordinary income in the year received
- 10% federal penalty applies to withdrawals made before age 59½ - a few exceptions applies
- Minimum distributions must begin no later than April 1st following the year the account holder turns age 70½

**Roth**

- Contributions are made by the individual account holder and are NOT tax-deductible
- Account holder must have earned income (income limits differ from those of a Traditional IRA)
- Account holder must NOT participate in an employer-sponsored retirement plan OR does participate in an employer-sponsored retirement plan and meets certain income requirements (income limits differ from those of a Traditional IRA)
- Distributions are NOT taxed if received on or after the account holder turns age 59½ and at least five years after the year in which the account holder made his first contribution to the account
- No minimum distributions requirement exists

**SEP**

- Contributions are made by the employer into traditional IRAs for each employee and each employee is 100% vested in the contributions
- Contributions are the lesser of 25% of the employee’s wages or $49,000 (in 2009 and 2010)
- 10% penalty applies to withdrawals made before age 59½ - a few exceptions applies
- Minimum distribution requirements exist and are the same as those for a traditional IRA

**SIMPLE**

- Contributions are made by both the employer and the employees into traditional IRAs; different contribution elections are available to the employer
- Minimum annual wage requirements apply to employees covered by the plan
10% penalty applies to withdrawals made before age 59 ½ - a few exceptions applies
Minimum distribution requirements exist and are the same as those for a traditional IRA

**KEOGH**
- Can be established as either a defined benefit plan or defined contribution plan, although defined contribution plan is most common (see below for details of each)
- Contributions are tax-deductible and limits vary based on the existence of other retirement plans in place
- Plan types included money-purchase plans, defined-benefit plans, and profit-sharing plans
- May use the same set of investments products as 401(k)s and IRAs
- 10% penalty applies to withdrawals made before age 59 ½ - a few exceptions applies
- Minimum distributions must begin no later than April 1st following the year the account holder turns age 70 ½

**DEFINED BENEFIT PLANS**

Pension plans, or defined benefit plans, generate a specific monthly payout (the defined benefit) to a retiree based on his individual salary history, years of service, and retirement age. The funding for these plans comes from the employer (in private-sector defined benefit plans) and employees seldom contribute any of their own money. The payments to retirees are guaranteed, regardless of the performance of the plan’s underlying investments or the longevity of the retiree. If the underlying investments do not perform as expected, or if retirees live longer than expected, the employer may have to increase contributions to the plan—bearing both the investment and longevity risks. Payments under these plans usually begin at retirement and are taxable as ordinary income when received.

Since the consumer does not usually contribute to defined benefit plans, they are a welcome source of retirement income. Unfortunately, the consumer has no control over the existence of such a plan or its permanence.

**DEFINED CONTRIBUTION PLANS**

Unlike defined benefit plans, defined contribution plans do not guarantee a specific payout amount at retirement. The amount contributed into the plan is defined, but the ultimate benefit is not. The retirement benefit will be determined based on a number of factors: the amount of money contributed into the account by the employer, the amount of money contributed into the account by the employee, the rate of investment growth, and the length of time the assets remain in the account (determined by the employee’s age at retirement). Investment decisions are usually made by the employee, who bears both the investment and longevity risks. Types of defined contribution plans include:

**401(k)** – This plan allows the employee to specify the amount of his income to be
deducted from his wages for contribution into the plan. Contributions are made pre-tax and they accumulate, along with interest credited, untaxed until they are withdrawn, at which time they are taxed as ordinary income. Contribution limits exist and, in many 401(k) plans, employers match a portion of the employee’s contributions or make other contributions. Penalties usually apply for withdrawals prior to age 59 ½ and minimum distributions must begin no later than April 1st following the year the account holder turns age 70 ½ OR the year the employee retires—depending upon plan provisions.

**Roth 401(k)** – This plan was introduced in 2006 and is similar to an individual Roth IRA in that contributions are made with after-tax dollars and distributions are received tax-free--if certain conditions are met. A few differences include the existence of minimum distribution limits, in-service distributions are restricted, and contribution limits equivalent to those of non-Roth IRAs.

**403(b) or Tax Sheltered Annuity** – This plan is similar to a 401(k) but is offered only to employees of educational, religious, and charitable organizations. Earnings grow tax-deferred until withdrawn, at which time they are taxed as ordinary income. Contribution limits are similar to those in 401(k)s, in-service withdrawals are usually restricted, the tax penalty usually applies to withdrawals made before age 59 ½, and the minimum distribution limit applies. A major difference between a 403(b) and a 401(k) is that a 403(b) may ONLY invest in annuities or mutual funds--most are invested in annuities.

**Roth 403(b)** -- This plan was introduced in 2006, when 403(b)s were permitted to offer designated Roth accounts. Designated Roth accounts are similar to those offered under a Roth 401(k) plan, as stated above.

**457** – This plan is a tax-exempt deferred compensation plan similar to a 401(k) but it is only available to federal and state employees and those employed by tax-exempt organizations. It does not allow employer contributions. Contributions may only be made through elective deferrals of an employee’s salary. Contribution limits are the same as those for 401(k)s, as are other features, except that 457 plans may not offer designated Roth accounts.

As with defined benefit plans, a consumer seldom has control over the existence of a defined contribution plan or its permanence.

**USING ANNUITIES TO FULFILL RETIREMENT GOALS**

In the previous section of this chapter, we briefly reviewed retirement vehicles that are alternatives to annuities. In addition to those listed, individuals may invest in many other ways. Some people purchase real estate with plans of selling it at a future date. Other people purchase stocks, bonds, mutual funds, certificates of deposit, and other investments.

Each retirement vehicle contains its own advantages and disadvantages and no one plan is right for every consumer. One big advantage an annuity has over other retirement
vehicles (except Social Security and a pension plan) is its ability to provide a guaranteed lifetime income. Another significant advantage is that an annuitant may deposit as much money as he wants into an annuity.

SUPPLEMENTING EXISTING RETIREMENT PLANS

Let’s say Steve is making the maximum contributions into his IRA, 401(k), or other retirement plan. What does he do when he realizes his contributions, and the anticipated return on his investments, will not generate enough retirement income? What does Steve do if his employer terminates his retirement plan? What if Steve is currently maximizing his tax deductions and is more concerned about his tax bracket, and taxation, at the time he begins withdrawing from his retirement plan? What if Steve doesn’t want to begin taking the minimum distribution from his retirement plan at age 70 ½?

Each of Steve’s concerns can be addressed by an annuity—so long as Steve understands that the purchase of an annuity involves a long-term commitment and his ability to leave his annuity assets untouched until at least age 59 ½.

**Scenario #1**
Steve makes his maximum contribution to his IRA, as well as the maximum contribution for his spouse. His employer doesn’t provide any retirement benefits. Steve received his Social Security Earnings Statement and has a good idea of what his Social Security monthly income will be at retirement. Unfortunately, the combined income from social security and his anticipated IRA distributions will be insufficient to meet his expenses when he retires.

Steve can purchase a deferred annuity, either on a qualified (pre-tax) or non-qualified (after-tax) basis, for the purpose of generating retirement income. Because the government, and the annuity contract itself, does not limit the contributions he can make, all Steve needs to do is calculate his financial needs at retirement and make flexible annuity payments based on those figures.

**Scenario #2**
Steve makes his maximum 401(k) contributions and his employer also contributes to the plan. He hasn’t purchased a personal retirement plan because, based on his calculations, the income generated by the 401(k), in addition to Social Security, will be more than enough for him to live on when he retires. Unfortunately, Steve’s employer sells the business and the new owner terminates the 401(k) plan.

Steve may purchase an IRA but its contribution limits are lower than those in his previous 401(k) plan are. In addition, he can also purchase a deferred annuity—as outlined in Scenario #1.

**Scenario #3**
Steve enjoys the tax-deductible contributions he makes to his 401(k) at work, but he doesn’t really need any more tax-deductions now. He’s more concerned about his tax bracket when he retires—his wife is ten years younger than he is and she’ll still be
working when he turns sixty-five. Steve can purchase a Roth IRA and/or a non-qualified deferred annuity to generate retirement income that will not be taxable when it’s received. Using both qualified and non-qualified vehicles, Steve will be able to control his level of taxation—both now and (hopefully) at retirement.

**Scenario #4**

Steve anticipates having more than enough money for his needs when he retires, especially since he’s not planning to quit working at age sixty-five. Both his parents worked well into their seventies and his grandfather worked part-time until he was ninety. He realizes that his current retirement funds will require him beginning minimum distributions at age 70 ½ but he’s concerned that he may not need funds at that time and doesn’t want to withdraw money he doesn’t need—and then be forced to pay taxes on it. If he purchases a non-qualified deferred annuity, he won’t have the minimum distribution requirements and can leave his assets in the account until he needs them.

**OTHER USES**

Some people use inheritances or life insurance death benefits, sell real estate, or liquidate other assets to fund retirement. The purchase of annuities may help them achieve their retirement goals when confronted with custody of a large sum of money. Depending up the tax consequences of their windfall (capital gains versus ordinary income) and other financial considerations, the purchase of an annuity is often beneficial. Because of the tax advantages, lack of contributions limits, and guarantee of lifetime income, annuities appeal to a wide variety of individuals, especially those who have enough financial resources to meet their current needs.

A producer should never recommend the purchase of an annuity until a suitability evaluation has been conducted. We will talk more about suitability later in this course.
CHAPTER 2 – REVIEW QUESTIONS

Answers are in the back of the text

1. All of the following are true of an annuity contract EXCEPT _____.
   [a] An annuity is a life insurance product
   [b] An annuity liquidates the principal sum and distributes it in periodic payments
   [c] Annuity payments begin at a specific time
   [d] Annuity payments must be made in a lump sum

2. All of the following are reasons people purchase an annuity EXCEPT _____.
   [a] Liquidity of principal
   [b] Tax treatment
   [c] Safety of product
   [d] Guarantees

3. One advantage an annuity has over other retirement vehicles is _____.
   [a] Its liquidity
   [b] It provides a lifetime income
   [c] Contributions are made tax-free
   [d] Distributions are always received tax-free
Chapter 3

Types and Classifications of Annuities

Annuities are offered in different types and classifications to meet the varying needs of consumers. The appeal of an annuity centers largely on its ability to provide tax-deferred growth of principal while also guaranteeing an income stream at a particular point in time, usually retirement. Annuities are long-term investments that involve two separate phases: the accumulation period (when the consumer pays into the annuity and his investment earns interest) and the annuitization, or payout, period (when the consumer receives periodic income payments from the annuity values).

The types and classifications of annuities are based on three distinct factors:

• When and how premiums are paid BY the consumer to the insurance company
• When benefits are paid TO the consumer by the insurance company
• Investment options offered by the precise annuity contract

The annuity type is based on the investment options chosen by the client; three types of annuities exist and they’re labeled Fixed, Indexed, or Variable. The premium payment classification of the annuity, regardless of type, is a further distinction and is categorized as being Single Premium or Flexible Premium. The final classification of the annuity depends upon when the annuity values are paid to the consumer. Regardless of the type of annuity, or its premium payment category, an annuity is identified as either Immediate or Deferred. Each annuity will contain a reference to type and will be distinguished further by the premium payment and benefit payout. For example, a client may purchase a Single Premium Immediate Fixed Annuity or a Flexible Premium Deferred Variable Annuity.

While fixed and indexed annuities accumulate savings at guaranteed rates and distribute income in guaranteed amounts, variable annuities accumulate savings and distribute income based on the performance of the investment vehicles in the subaccounts chosen by the contract owner.

ANNUITIES BY PREMIUM PAYMENT CLASSIFICATION

When a consumer purchases an annuity, he has a number of options with respect to premium payment. He can deposit one lump sum into the annuity or he may make payments over a period of time.

SINGLE PREMIUM ANNUITY

A single premium annuity is purchased with a lump sum amount. For example, a
consumer gives the insurance company $50,000 in exchange for the annuity contract. The lump sum premium may have come from a savings account, liquidation of another financial vehicle, sale of an asset, inheritance, etc. Once the single premium payment is made, no further deposits are made into the annuity. This premium payment option is most often selected when purchasing an Immediate Annuity (see below) but can also be chosen when purchasing a Deferred Annuity (see below).

**Flexible Premium Annuity**

A flexible premium annuity is purchased with premium payments made on a regular basis over time OR as the consumer’s financial status allows. For example, a consumer may choose to make monthly, quarterly, semi-annual, or annual payments into his annuity or he may choose to make premium payments based on the size of his annual tax return, profit-sharing bonus, or other situation. A consumer may also choose to make regular payments AND sporadic other payments, as his circumstances permit. This premium payment option is selected when purchasing a Deferred Annuity (see below).

**Annuities by Benefit Payout Classification**

After a consumer purchases an annuity, he will begin receiving a distribution of the annuity values at some point. He has two options: to begin receiving his distributions right away or sometime in the future. The consumer makes the decision about when to receive distributions. However, in certain cases involving qualified annuities (annuities paid with pre-tax dollars), the consumer must begin taking required minimum distributions (RMD) at a specific age. We’ll discuss these required minimum distributions later in the course.

**Immediate Annuity**

An immediate annuity is purchased with a lump sum payment and the consumer begins receiving distributions right away. This type of annuity does not have an accumulation period; it only has a payout—or annuitization—period. If the annuity owner chooses to receive monthly payments, the payments usually begin at the end of the first month after the purchase but may start at any time within the first year of the contract. For example, a consumer may take his 401(k) savings and use them to make a single premium payment into an immediate annuity and immediately begin receiving a monthly income.

**Deferred Annuity**

A deferred annuity may be purchased with either a single premium or flexible premiums. It contains both an accumulation period (period when premium payments are made and they earn interest) and an annuitization, or payout, period. The payouts do not begin right away, as with an immediate annuity; they begin at some point in the future, thus the classification *deferred*. For example, a consumer may make a $50,000 single premium payment into his annuity today, when he is fifty years old, and choose to begin receiving his distributions when he retires at age sixty-five. Another example involves a forty year-
old consumer who chooses to make payments of $100 per month into his flexible annuity, because he doesn’t have a lump sum of money. He plans to save for retirement and will opt to begin receiving distributions at some future point in time; the average consumer usually doesn’t choose a retirement date twenty-five years in advance.

ANNUITIES BY INVESTMENT OPTION

Annuities come in three basic types: Fixed, Indexed (a type of fixed annuity), and Variable. A variable annuity is considered both an insurance AND a securities product and may only be sold by a licensed life insurance producer to whom a securities license has also been issued. Each type of annuity contract contains its own investment options—each of which appeals to different consumers for different reasons. Some people prefer many guarantees when investing in their retirement; others prefer to assume a degree of risk. It is especially important for seniors to choose an annuity that best meets their needs because of the limited length of time of their accumulation periods and because of the contract provisions, most notably the surrender charge term and surrender charges and penalties.

FIXED ANNUITY

The fixed annuity is the oldest type of annuity. With a traditional fixed annuity, the insurance company guarantees the amount of premium payments made into the annuity (called the principal), a minimum rate of interest on the principal, and a minimum payout amount when the contract payout begins (the annuitization period). The current credited rate of interest for fixed annuities is determined, subject to minimum guarantee requirements, and declared by the insurance company based on the investment performance of its general account assets. If the insurance company increases the current credited interest rate, which it often does, it usually applies the increased rate to funds received after the change effective date for “new money” paid into the annuity. If the insurance company reduces the current credited interest rate, it cannot fall below the guaranteed minimum interest rate stated in the contract. The interest rate is usually guaranteed for a year at a time on existing annuity values. Some fixed annuities offer a multi-year rate guarantee.

Fixed annuities usually involve less investment risk than variable annuities because they offer a guaranteed minimum interest rate. This guaranteed interest rate is not affected by market fluctuations or the insurance company’s annual profits. Many consumers are attracted to fixed annuities because of their security: their payouts will never vary and they guarantee a minimum amount of credited interest. While fixed annuities are less risky than variable annuities, they offer fewer investment options and less opportunity for growth than variable annuities do.

INDEXED ANNUITY

Indexed annuities have accounted for a large portion of annuity sales since being introduced in the mid-1990s and are a type of fixed annuity. The investment return in an indexed annuity is not credited based on a declared rate of interest; instead, it is based on
a formula that is applied to an external financial index such as the S & P 500®, the Dow Jones Industrial Average®, or the Lehman Aggregate Bond Index®.

While an indexed annuity guarantees no less than a stated fixed return on the investment, which is common among all fixed annuities, it also allows for greater investment growth than a traditional fixed annuity does. On the other hand, when compared to a variable annuity, it doesn’t offer the variety of investment options or the same opportunity for growth.

Some indexed annuities offer riders that guarantee income for life, even if the annuity value declines to $0. Indexed annuity contracts have a number of interest crediting features, which we will discuss later in this course.

**VARIABLE ANNUITY**

Variable annuities are securities products; therefore, they are regulated by state and federal securities laws. Only an insurance producer who is also securities licensed may sell a variable annuity. The sale of a variable annuity must always be accompanied by the delivery of a prospectus to the applicant.

FINRA, The Financial Industry Regulatory Authority, is the non-governmental regulator for all securities firms doing business in the United States and, as such, serves as the federal level regulator for variable annuity sales. FINRA was created in July 2007 when the NASD consolidated with the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE).

Variable annuities have evolved into sophisticated securities vehicles with a combination of securities and insurance features. Contract owners may choose from a variety of investment options, called subaccounts. Each subaccount invests in shares of a single, underlying mutual fund; sometimes, subaccounts invest in a “fund of funds,” which is a mutual fund that invests in several other mutual funds or exchange-traded funds (EFTs). Variable annuity contract owners choose the allocation of their contract value among equity funds, bond funds, funds that combine equities and bonds, actively managed funds, index funds, domestic funds, and international funds. Unlike mutual funds available for purchase by the general public, the mutual funds available in the subaccounts of a variable annuity (or a variable life insurance policy, or sometimes in an IRA, 401(k), etc.) are only available to those investing in variable annuities (or the other permitted contracts).

When a variable annuity contract owner chooses to transfer assets between subaccounts, he may do so tax-free. This option is appealing because the contract owner may make investment choices based on his needs and strategy without concern for the tax consequences.

Variable annuities offer fewer guarantees than fixed and indexed annuities do; they also involve more investment risk. We will discuss more details and characteristics of all three types of annuities in Chapter Five.
OTHER ANNUITY FACTS

INSURANCE GUARANTEE ASSOCIATION

Because fixed and indexed annuities are considered life insurance products, they are protected by the California Life & Health Guarantee Association—up to a maximum of $100,000 for all annuities sold by an admitted California Life Insurance Company. Variable annuities are not subject to the protection of the California Life & Health Guarantee Association except for those assets invested in the fixed account option in a variable contract.

GROUP ANNUITIES

While most annuities are sold to individuals to fund their personal retirement income, group annuities are most commonly sold to fund employer-provided qualified retirement plans during the accumulation period. Situations exist when a group annuity is used to fund the retirement income stream from an employer-provided retirement plan if the employer invested in non-annuity assets during the accumulation period (such as in a defined benefit plan).

In this situation, each employee obtains his annuity certificate when he reaches retirement and receives all future retirement income directly from the annuity. Occasionally, an employer will utilize a group annuity when it terminates a defined benefit retirement plan (sometimes required by the Pension Benefit Guaranty Corporation). In the case of a plan termination, employees will receive an annuity well before they reach retirement age.

The sales process for a group annuity usually occurs at the employer level. Group annuities contain lower fees and commissions paid than individual annuities do, therefore, they tend to have shorter surrender periods and smaller surrender charges.

CHOOSING AN ANNUITY

Because insurance language and terminology is often confusing to consumers, asking the consumer questions about his needs, financial situation, and goals is a better way of helping him choose the type of annuity to purchase than it is to ask, So, Mr. Consumer, do you want to buy a fixed or variable annuity?

Here are some of the questions a producer might ask to make the process less confusing for the consumer and more illuminating for himself as he prepares to make his recommendation:

- How are you going to pay for the annuity?
  - If the consumer answers, With savings or any other single source of a lump sum of money, it may mean he wants to make a single payment
  - If he replies, Can I Make Monthly (or Regular) Payments? this usually indicates that his financial situation requires a flexible annuity
• How soon do you want your income payments to begin?
  o If the consumer answers, *Right away* it probably means an immediate annuity is best
  o If he replies, *I don’t know* or *At retirement* or *In the future*, it’s likely a deferred annuity is best

• How would you like your money invested?
  o If the consumer answers, *I don’t want to lose my principal* or *I don’t want anything high-risk* or *I’m looking for guarantees*, it usually means he will prefer a fixed annuity
  o If he replies, *May I choose my own investment options?* a variable annuity might be the best way to go

Many consumers possess some knowledge of annuities and much of that knowledge is obtained from someone else—usually not an insurance producer. A consumer may tell you he likes fixed annuities because his co-worker told him that’s the best kind to buy—but he doesn’t have any personal knowledge about the contract. He may also believe that a variable annuity is the way to go because he can choose his investment subaccounts but, when you attempt to explain his options, they may be too complicated for him to understand—or he may not like the risk-factor intrinsic to a variable annuity.

Annuities are complex insurance and/or securities contracts that need to be explained thoroughly before they are sold. A suitability evaluation, a risk tolerance worksheet, and the consumer’s investment objectives need to be evaluated before a producer recommends ANY type of annuity, regardless of the consumer’s initial thoughts about what product he wants to buy.
CHAPTER 3 – REVIEW QUESTIONS

Answers are in the back of the text

1. The appeal of an annuity centers on its _____.
   [a] Status as a life insurance policy
   [b] Ability to provide tax-deferred growth of principal
   [c] Status as a securities product
   [d] Ability to provide tax-free growth of principal

2. A flexible premium annuity _____.
   [a] Is purchased with a lump sum payment
   [b] Is purchased with premiums made over a period of time
   [c] Is purchased to make flexible payments over time
   [d] Is purchased to guarantee the consumer with flexibility

3. A(n) _____ annuity is purchased with a lump sum payment and the consumer begins receiving distributions right away.
   [a] Variable
   [b] Immediate
   [c] Single premium
   [d] Indexed annuity

4. _____ may sell variable annuities.
   [a] A person holding a life insurance producer’s license
   [b] A person holding a securities license
   [c] A person holding a life insurance producer’s license and a securities license
   [d] A person holding a broker/dealer license
Chapter 4

The Parties to an Annuity

Most annuity contracts, and all commercial/group annuity contracts, are issued by life insurance companies. The annuity application stipulates the parties to the contract:

- The insurance company
- The contract owner
- The annuitant
- The beneficiary

Insurance Company

The life insurance company issuing the annuity contract must be duly authorized and licensed to transact life insurance business in the state of California. If the contract is a variable annuity, the insurance company must also be licensed to sell and transact securities business in the state of California.

Owner

The annuity contract owner is responsible for paying the premiums. He has the most rights provided under the contract, including the right to make payments and contributions, the right to make withdrawals, the right to cancel the contract, and the right to make changes to the contract. The owner is usually an individual or a couple (such as a husband and wife) but may also be a trust, partnership, or corporation. Special tax rules apply to annuity contracts owned by a party that is not a natural person.

For example, Earl owns an annuity and his wife Ethel is the annuitant. Earl has the right to make premium payments. Earl may change the amount or regularity of the premium payments, he may choose to withdraw money from the annuity, or he may choose to cancel it. Earl may also name the beneficiary and then, subsequently, change it. Ethel, although the annuity is based on her life, does not have the right to do any of these things.

Minimum and maximum age limits usually apply to the annuity contract owner. Some insurance companies will not permit an annuity owner to be under the age of eighteen; most will. The maximum age of the annuity contract owner depends upon the insurance company’s guidelines and ranges between 60 and 90, with the majority of maximum ages being 85 or 90.

Annuitant

The annuitant is the person upon whose life the annuity contract is based. Minimum and maximum age limits usually apply to the annuitant. Unlike the insured person on a life
insurance policy, medical underwriting is not a consideration. Some insurance companies will not permit an annuitant to be under the age of eighteen; most will. The maximum age of the annuitant depends upon the insurance company’s guidelines and ranges between 60 and 90, with the majority of maximum ages being 85 or 90.

The annuitant may also be the owner of the annuity contract, but does not have to be the owner. Two people may be joint annuitants, such as a husband and wife, and this type of annuity would be called a joint and survivor annuity.

An annuitant is similar to the insured on a life insurance policy because the accumulation period ends when the annuitant dies. An annuity provides no rights to the annuitant. If the annuitant is also the owner, then he possesses any rights because of his status as contract owner, not because of his status as annuitant.

For example, let’s use the previous scenario where Ethel is the annuitant and her husband Earl is the owner. So long as Ethel is alive, Earl may do all the things to which he is entitled as owner. Ethel has no rights in the contract. But if Ethel was both the annuitant and the contract owner, she would have all rights of ownership.

Minimum and maximum age limits usually apply to the annuitant. Unlike the insured person on a life insurance policy, medical underwriting is not a consideration. Some insurance companies will not permit an annuitant to be under the age of eighteen; most will. The maximum age of the annuitant depends upon the insurance company’s guidelines and ranges between 60 and 90, with the majority of maximum ages being 85 or 90.

**Beneficiary**

The beneficiary of an annuity is the person, persons, or entity designated in the contract by the owner to receive payments due upon the death of the owner or annuitant. More than one beneficiary may be named. For example, let’s use the preceding scenario where Ethel is the annuitant and her husband Earl is the contract owner. Earl may name himself as beneficiary or he may choose to name himself and his daughter as beneficiaries, with his daughter receiving 20% of the annuity payout and himself receiving 80% of the payout. In a different scenario, let’s say Earl is both the annuitant and owner of his own annuity. He may want to name Ethel and his daughter as beneficiaries, with each receiving 50% of the annuity payout when he dies. In a third example, Earl chooses to name the Humane Society of California as the beneficiary in his annuity.

Beneficiaries, like annuitants, do not have rights in annuity contracts. The role of a beneficiary is to receive the payout from an annuity when the annuitant dies. Minimum and maximum age limits do not apply to beneficiaries.

**Respective Rights of the Parties**

Because insurance companies establish their own guidelines for payout provisions, the
respective rights of the owner, annuitant, and beneficiary may differ from insurance company to insurance company. For example, Company A’s insurance contract may allow only the owner or beneficiary to receive the annuity payout. Company B’s contract, however, may also allow the annuitant to receive the payout.

In most cases, the beneficiary named in an annuity contract is a family member of the annuitant or someone who is financially dependent upon the annuitant. For example, if Ethel were the annuitant, it would be common for her husband Earl to be named beneficiary. If her daughter is financially dependent upon Ellen, she might also be named beneficiary.

In cases where the owner and annuitant are the same person, the owner/annuitant is very likely to name a family member or dependent as beneficiary for the same reasons stated in the previous paragraph.

In all cases, the owner makes the decisions about beneficiary designations and the annuitant and beneficiary are simply parties to the contract. It should be noted, however, that an annuity cannot be purchased on the life of an individual without his permission. Even though the owner applies for the annuity contract, the annuitant must also sign the application indicating his consent to, and participation in, the annuity.

RIGHTS AND OBLIGATIONS OF THE INSURANCE COMPANY

California Insurance Code (CIC) protects the rights of consumers by declaring required and prohibited practices with respect to the sales of insurance. Producers should be familiar with CIC concerning all products they sell and service and should pay particular attention to those pertaining to annuities. Because of the increased number of complaints against California producers with respect to the sale of annuities, it is especially important for producers to be aware of insurance code and to comply with it in all respects. The following requirements of CIC apply specifically to annuity sales to seniors in the State of California.

FREE LOOK

All states require insurance companies to provide policyholders the option to return an individual insurance policy or annuity for a full refund within a certain number of days after purchase. This option is called the Free Look period and the number of days provided from the date of delivery of the contract varies from state to state and also depends upon the type of contract and the party to whom it is sold. CIC requires all individual annuity contracts sold or delivered to senior citizens in the State of California to contain a notice, printed on the policy or attached to it, indicating that the contract owner has the right to return the policy for a full refund within a specified number of days that can be no fewer than thirty (30) days. The language to be contained in the notice is stipulated in insurance code and must be printed in a font no smaller than 12-point bold; different disclosures are used for fixed and variable annuities. If the policy is returned within the Free Look period, it must be returned to the insurance company that
issued it or to the producer who sold it in order to avoid surrender charges and penalties.

Insurance companies must cancel individual contracts as follows if they are returned within the Free Look period:

**VARIABLE CONTRACTS WITH NO DIRECTION TO INVEST IN MUTUAL FUNDS**

Return of the policy during the cancellation period will have the effect of voiding the policy from the beginning and the parties will be in the same position as if no policy had been issued. All premiums, and any policy fee, paid will be refunded by the insurance company to the contract owner within 30 days from the date the insurance company is notified that the owner has canceled the contract.

**VARIABLE CONTRACTS WITH A DIRECTION TO INVEST IN MUTUAL FUNDS**

Return of the policy during the cancellation period will entitle the owner to a refund of the account value. The account value will be refunded by the insurance company to the contract owner within 30 days from the date the insurance company is notified that the owner has canceled the contract.

**CONTRACTS EXCEPTED**

This section of insurance code does not apply to life insurance and annuity policies issued in connection with a credit transaction, under a contractual policy change or conversion privilege provision contained in a policy, contributory and non-contributory employer group life insurance, contributory and non-contributory employer group annuity contracts, and group term life insurance.

**DEFINITION OF SENIOR CITIZEN FOR THIS CHAPTER OF CIC**

For purposes of this chapter of the California Insurance Code, a senior citizen means an individual who is 60 years of age or older on the date the annuity was purchased.

**ILLUSTRATIONS**

If an insurance company or insurance producer sells or delivers an annuity to a senior in the State of California using illustrations that discuss values that are not guaranteed, and the illustration is not a pre-printed illustration provided by the insurance company, a specific disclosure must be contained on the illustration as follows:

- In bold or underlined capitalized print, or
- In a sticker of a contrasting color, or in highlighted text, or in any manner that makes it more prominent than the surrounding text, and
- With at least one-half inch of clear space on all four sides, and which reads:
  - *This is an illustration only. An illustration is not intended to predict actual performance. Interest rates, dividends, or values that are set forth in the illustration are not guaranteed, except for those items clearly labeled as guaranteed.*
If a pre-printed illustration is used, the same disclosure appearing above must be contained either on the illustration or on an attached cover sheet in 12-point bold print with the same one-half inch of clear space on all four sides of the notice. In addition, the pre-printed illustration must show guaranteed values in bold print and all other values must appear in standard print. (Values include cash values, surrender values, and death benefits.)

**ANNUAL STATEMENTS**

Insurance companies are required to provide the following values in all annual statements issued to senior citizen annuity contract owners in the State of California: current accumulation value and the current cash surrender value.

**SURRENDER CHARGES**

If an insurance company issues an annuity contract to a senior citizen in the State of California and the contract contains a surrender charge period, the insurance company must:

- Disclose the surrender period and all associated penalties in 12-point bold print on the cover sheet of the policy, or
- Disclose the location of the surrender information in bold 12-point print on the cover page of the policy, or
- Show the disclosure printed on a sticker that is affixed to the cover page or to the policy jacket, or
- Include the disclosure on the Free Look disclosure

**REPLACEMENT**

Cancelling or surrendering an annuity contract for the purpose of exchanging or replacing it for a new contract is not always in the best interests of the consumer. Most producers handle the replacement of annuity contracts in a legal and ethical manner. In order to protect consumers from the occasional dishonest practitioner, California has (as have most other states) enacted legislation concerning the replacement of life insurance and annuity products.

When a producer completes an application for the sale of an annuity, he must sign a statement that becomes part of the application indicating whether replacement is—or may be—involved in the transaction. If replacement is, or may be, involved, the producer must supply the insurance company with the following information:

- A list of all policies to be replaced, including policy numbers, insurance company names, and insured persons
- A copy of the replacement notice required by CIC

Within three business days of the proposed insurance company’s receipt of the signed annuity application, or the date the annuity contract is issued—whichever occurs first, the insurance company must then send written communication to the insurance companies of
the existing policies; the written communication must contain the following:

- A notice that replacement of the policy or policies is anticipated
- Identification information concerning the existing policy/policies to be replaced
- A policy summary, ledger summary, or ledger statement containing policy data on the proposed annuity contract

The insurance companies of the existing policies must send to the policy owner, within twenty days of their receipt of the written communication concerning replacement, policy summaries or ledger statements containing policy data about the existing policies. Information relevant to premiums, cash values, death benefits, and dividends on the existing policy must be calculated from the current policy year. The policy summaries and ledger statements must also include the amounts of any outstanding loans or indebtedness, dividend accumulations or dividends, and any other information that does not violate statute.

When the replacement policy is issued, the insurance company must provide written notice, either in the policy or on a separate document, stating that the applicant has the right to an unconditional refund of all premiums paid (this is the Free Look period); this right begins on the date of policy delivery and must be exercised within thirty (30) days.

**INSURANCE COMPANY FINANCIAL STABILITY**

The financial stability of insurance companies is rated by a number of independent rating organizations such as A.M. Best Company, Standard & Poor’s, Moody’s Investors Services, etc. Producers should be sure to confirm and document the financial ratings of any insurance company they represent. Although most suitability forms and worksheets do not require this information, it is essential for the producer to represent only the most reputable of companies for the protection of their clients and the clients’ assets.

Insurance companies are not backed by the FDIC or other federal authorities. If an insurance company is licensed in the state of California, its annuitants may be partially protected by the California Life and Health Insurance Guarantee Association (CLHIGA) in the event of the financial failure of the insurance company. Any portion of the contract not guaranteed by the insurance company, or under which the risk is borne by the annuitant, is excluded from CLHIGA protection.

**ADVERTISING**

Many consumers believe that if the media makes a pronouncement, or printed materials make a claim, the facts—as stated, must be true. Nothing could be further from the truth. The United States Constitution guarantees its citizens the right to speak freely—whether verbally or in writing. Because of this freedom, it is quite easy for an individual or other entity to mislead consumers in its advertising.

California Insurance Code, as we’ve mentioned previously, was designed to protect consumers from all manner of unethical and illegal sales practices. It is especially important for producers to be aware of “elder abuse,” which is defined by the National
Committee for the Prevention of Elder Abuse, in part, as “undue influence of an individual who is stronger or more powerful making a weaker individual to do something that the weaker person would not have done otherwise. The stronger person uses various techniques or manipulations over time to gain power and compliance.”

In California, it is illegal for a producer to use a senior designation when soliciting or selling annuities to senior citizens unless certain standards and requirements are met. In CIC, the phrase *senior designation* means any degree, title, credential, certificate, certification, accreditation, or approval that expresses or implies that a producer possesses expertise, training, competence, honesty, or reliability with regard to advising seniors on finances, insurance, or risk management.

A producer may not use a senior designation unless all of the following conditions have been met:

- The producer has been granted the right to use the senior designation by the organization that issues the senior designation, and the producer is currently authorized by the organization to use the designation.
- The senior designation has been approved by the commissioner for use by producers in the sale of insurance to seniors.
- The producer has been licensed for at least four years to sell the types of insurance with which the designation is used.

Producers are not permitted to use senior designations in a manner that misleads a person as to the significance of the senior designation. Each time a producer uses a senior designation in a writing, the writing shall also contain the words "California" or "CA" next to "Insurance Agent" or "Insurance Broker Agent" and "License," and these words will be located immediately prior to the producer’s license number, in type that is in the same font and at least the same size as the type used for the senior designation.

CIC stipulates a number of conditions before a senior designation may be granted by the insurance commissioner, including the senior organization’s fulfillment of the following:

- Applicants for the designation to complete a minimum number of hours of education in topics approved by the commissioner before granting them the right to use its senior designation. The courses must be relevant to the sale of insurance to seniors.
- The organization must be exclusively an educational or certificate organization, and is not directly or indirectly involved in selling insurance, nor does it receive any compensation from the sale of insurance.
- The organization maintains reasonable standards and procedures for disciplining its designees for improper or unethical conduct.
- Imposes reasonable continuing education requirements or other means of periodically verifying a designee’s knowledge and skill in order for designees to retain the senior designation in good standing.
- Maintains a code of ethics for its designees.
- Maintains reasonable standards and procedures to test for proper mastery of the knowledge and skill required to receive the senior designation.
Any person who grants to a California resident the right to use a senior designation that has not been approved by the commissioner, without reasonably attempting to determine whether California is one of the designee's residences, will be subject to a cease and desist order and monetary penalty pursuant to insurance code as if the person had acted in a capacity for which a license was required but not possessed. These penalties will be imposed in addition to any other disciplinary and remedial authority included in CIC.

A producer holding a senior designation that was obtained before January 1, 2009 may continue to use that designation until June 30, 2010, IF the organization that issued it meets the requirements of code and certifies in a letter to the producer that he or she has completed at least 75 hours of education in topics relevant to the sale of insurance to seniors.

**Penalties for Failure to Promptly Issue Cancellation Refunds**

When a consumer cancels an annuity, regardless of the reason for the cancellation, certain surrender charges and penalties usually apply, thus diminishing the value of the contract. It is for this purpose that California Insurance Code (CIC) requires disclosure at issue or delivery of the annuity contract concerning the terms of policy cancellation, cancellation refunds, and the consumer’s right to change his mind about making the annuity purchase, as stated in the previous sections of this chapter.

If an insurance company issuing an annuity contract fails to refund all of the premiums paid in a timely manner upon return of the contract for cancellation, then the contract owner is entitled to receive interest on the paid premium at the legal rate of interest on judgments as provided in Section 685.010 of the Code of Civil Procedure. The interest will be paid from the date the insurance company or producer received the returned policy or certificate.

**Beneficiaries’ Rights and Settlement Options**

Beneficiaries are the persons or entities selected by the annuity contract owner to receive the annuity values when the annuitant dies. Once a contract owner makes his payout option selection, it can seldom be changed.

Deferred fixed annuities offer fixed payout options. Deferred variable annuities, however, sometimes offer either fixed or variable payouts. When the insurance company makes fixed payments, a specific dollar amount is paid on a regular basis (usually monthly) for the term of the payout period. When the insurance company makes variable payments, the amount of each payment is not guaranteed and changes with the performance of the underlying portfolio selected by the owner of the variable annuity contract. Options in the variable annuity contract are sometime available to minimize fluctuations in payments; they include a provision allowing for level payments (which apply for a certain period of time) or a provision stabilizing guarantees (which provide a minimum payment amount, regardless of performance).
**LIFE ANNUITIES**

When a life annuity payout is chosen, it provides a guaranteed income for the lifetime of the annuitant or the beneficiary. When the annuitant or beneficiary dies, payments cease and do not continue to beneficiaries.

**JOINT AND SURVIVOR ANNUITIES**

When a joint and survivor annuity contract is issued on a couple (usually a husband and wife), or if the beneficiary opts for a joint and survivor payout, the contract provides a payout for as long as either of the two annuitants/beneficiaries is alive. The amount of each payment is usually less than if it were based on a single individual. They may choose to have payments remain the same or decrease after the death of the first annuitant. For example, after the first annuitant/beneficiary dies, they may choose to have payments reduce to two-thirds of the amount paid while both annuitants were alive. This is called a joint and two-thirds annuity.

**PERIOD CERTAIN ANNUITIES**

When a period certain payout is chosen by an annuitant or beneficiary, payments are guaranteed to continue for a specified time, regardless of how long the individual lives. For example, the period certain may be five years or ten years; most companies offer periods ranging from five to thirty years. If the individual dies before the period has expired, payments continue to the designated beneficiaries for the duration of the period certain. For example, if a ten-year period certain were chosen and the individual dies in year six, his beneficiaries will continue receiving payments for the next four years—until the ten-year period certain expires.

**LIFE WITH PERIOD CERTAIN ANNUITIES**

When a life annuity with a period certain payout option is chosen by an annuitant or beneficiary, payments are guaranteed for the lifetime of the individual and also guarantee that payments will continue to the designated beneficiaries for a specific period of time IF the individual dies before the specified period expires. For example, if the individual chose a life annuity with a ten-year period certain and dies in year eighteen, his beneficiaries will not receive any payments because he died after the period certain term expired. On the other hand, if the individual dies in year four, his beneficiaries will receive payments for the next six years, until the period certain term expires.

**REFUND ANNUITIES**

When a life annuity option is chosen, payments stop when the individual dies. If the individual dies after receiving one payment, the balance of the annuity values are retained by the insurance company and no additional payments will be made. Some individuals prefer to avoid this possibility by setting up a life annuity with a refund feature. This feature reduces the amount of each monthly payment, but it does guarantee the principal.
Two types of refund annuities are available to pay a refund to the designated beneficiaries if the annuitant dies before the total of the annuity payments he received equals the premiums paid for the annuity.

**Cash Refund Annuity** -- This type of payout allows for a lump sum refund of the premiums paid before the annuitant’s death, and to the beneficiaries, minus the annuity payments already made to the annuitant before his death.

**Installment Refund Annuity** -- This type of payout allows for installments payments to the beneficiaries until the total amount paid out to the annuitant before his death, and to his beneficiaries, equals the amount of premiums paid into the annuity.

**CALIFORNIA SENATE BILL 483**

The bill would require an individual, as a condition of eligibility for medical assistance for home and facility care, to disclose a description of any interest that the individual or his or her spouse has in an annuity, as specified. The bill would also require the state, as an operation of law, to become a remainder beneficiary of certain annuities unless the individual notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary, as provided, and would require the department to inform an individual and his or her spouse of this fact at the time of the individual’s application or redetermination of Medi-Cal eligibility.

If an individual or his or her spouse notifies the state in writing that he or she prohibits the state from becoming a remainder beneficiary to his or her annuity, the bill would require the annuity to be treated as a transfer of assets for less than fair market value for purposes of determining Medi-Cal eligibility. “Annuity,” as defined in CIC with respect to SB 483, means a contract that names an annuitant and gives a person or entity the right to receive periodic payments of a fixed or variable sum for a described period of time, which may include a lump-sum payment or periodic payments upon the death of the annuitant.

**MISCELLANEOUS**

Annuities are life insurance contracts, which means that annuity values are passed along to beneficiaries without having to go through probate. Usually, the payments made to the beneficiary of an annuity contract will be subject to the same taxation provisions as the annuitant.

Beneficiaries must make one of the following elections when the annuitant dies:

- Take an immediate lump sum, or
- Complete all withdrawals within five years of the annuitant’s death, or
- Take annuitization over the life of the beneficiary to start within one year of the annuitant’s death; if a spouse is the sole beneficiary (or surviving owner), the spouse can also elect to continue the contract.
- If the owner is a grantor trust, the death of the grantor triggers mandatory
distribution.
CHAPTER 4 – REVIEW QUESTIONS

Answers are in the back of the text

1. All of the following are parties to an annuity contract except_____.
   [a] Insurance Company
   [b] State of California
   [c] Annuitant
   [d] Beneficiary

2. The _____ has most of the rights in an annuity contract.
   [a] Owner
   [b] Annuitant
   [c] Beneficiary
   [d] Insurance Company

3. For purposes of compliance with the Free Look period of an annuity sold to a senior
   in the State of California, a senior is an individual who is _____ years of age or
   older on the date the annuity was purchased.
   [a] 55
   [b] 60
   [c] 65
   [d] 70

4. The Free Look period for an annuity sold to a senior in the State of California that
   involves replacement is _____ days.
   [a] 10
   [b] 20
   [c] 30
   [d] 60

5. When a _____ is chosen by an annuitant, payments are guaranteed to continue for a
   specified time, regardless of how long the annuitant lives.
   [a] Life annuity payout
   [b] Joint and survivor annuity payout
   [c] Refund annuity payout
   [d] Period certain payout
Chapter 5

How Fixed, Indexed, and Variable Annuity Contract Provisions Affect Consumers

COMMON ANNUITY CONTRACT PROVISIONS

Each insurance company issues its own contracts and, while the contracts of all insurance companies have standard provisions, each contract should be read and reviewed by the producer to confirm that the best product is being recommended to the consumer—based on his needs, financial status, and investment objectives.

The State of California also has requirements that apply to annuity contracts and life insurance products; each annuity contract sold in the state of California must comply with California Insurance Code (CIC) in addition to any other requirements.

ISSUE AGES

Insurance companies have a number of requirements and guidelines to consider before issuing life insurance and annuity contracts. When considering an applicant for issuance of a life insurance policy, for example, the insurance company needs information pertaining to not only the age and gender of the applicant, but to his medical history, occupation, hobbies, and other matters. The premium charged for a life insurance policy is a direct reflection of the risk the insurance company bears. A sixty year-old insured will pay a higher life insurance premium than a twenty-five year old insured will. Similarly, a twenty-five year-old insured who smokes will pay a higher life insurance premium than a twenty-five year-old who has never smoked.

When considering an applicant for issuance of an annuity contract, however, insurance companies require less information. The health of the owner or insured person in an annuity contract does not affect the premiums charged. The purpose of an annuity is precisely the opposite a life insurance policy. Life insurance provides protection against (and funds for) premature death; an annuity protects a long-lived individual from running out of money by providing funds for life.

The ages of the owner and annuitant in an annuity contract are important, for a number of reasons. Most insurance companies allow anyone to purchase an annuity from the time of birth (Issue Age 0) to a maximum age that typically ranges from 75 to 90, depending upon the insurance company and the type of annuity.

The subject of legal capacity often arises in cases involving the sales of annuities, especially with respect to senior consumers. Legal capacity is the term used to define the ability of a person to understand and appreciate the consequences of his/her actions. A
person who lacks legal capacity cannot, for example, enter into a contract, give a power of attorney, make a will, consent to medical treatment, or transfer property. Minors typically lack legal capacity, as do individuals who are mentally handicapped or under the influence of alcohol. The older we become, the more likely we are to develop a mental disease or disability such as Alzheimer’s disease or dementia, which diminishes both our legal and mental capacity.

The State of California permits minors to enter into annuity contracts for the benefit of themselves or for the benefit of the father, mother, husband, wife, child, brother, or sister of the minor. It also permits a minor, subject to written consent of a parent or guardian, to purchase an annuity upon the life of any person in whom the minor has an insurable interest for the benefit of himself or the minor's father, mother, husband, wife, child, brother, or sister. CIC states that a minor does not lack legal capacity to enter into an annuity contract simply by virtue of his minority. It does state, however, that any minor under the age of sixteen must have the written consent of a parent or legal guardian to enter into an annuity contract. All such contracts made by a minor not yet age 18 years, which may result in any personal liability for assessment, will have the written assumption of any such liability by a parent or guardian in consideration of the issuance of the contract.

Most insurance companies require maximum issue ages of annuitants and owners based upon life expectancy tables and minimum required distribution limits. For example, most qualified annuities (annuities where premium payments were made with pre-tax dollars) require that the owner begin taking minimum distributions beginning no later than April 1st of the year in which the owner turns age 70 ½. As a result, insurance companies stipulate a maximum issue age of 75 or 80 for the owners of qualified annuities and ages ranging from 80 to 90 for the owners of non-qualified annuities.

**MAXIMUM AGES FOR BENEFITS TO BEGIN**

In non-qualified annuities (annuities where premium payments were made with after-tax dollars), there is no requirement stipulating when benefits must begin being paid by the insurance company to the annuity owner. That is not the case with qualified annuities.

Beginning on April 1st of the year following the year in which the owner turns age 70 ½, required minimum distributions (RMD) must begin taking place if the annuity is a qualified contract. If the annuity offers a 10% annual withdrawal amount, this provision will likely allow sufficient penalty free withdrawals to comply with the required minimum distribution requirements—due to actuarial factors. Even with the 10% annual withdrawal exception, however, a consumer should not be sold an annuity that does not allow for the required minimum distributions to occur without surcharge or penalty.

**PREMIUM PAYMENTS**

Life insurance companies authorized to do business in the state of California may collect premiums in advance if they issue policies on a reserve basis. They may also accept funds for the payment of future premiums related to any policies they issue.
Insurance companies may not accept funds in an amount that exceeds either a) the sum of future unpaid premiums on any policy, or b) the sum of ten future unpaid annual premiums on any policy if the sum is less than the sum of future unpaid premiums on any policy.

Insurance companies may accept funds under an agreement that provides for an accumulation of premium payments for the purpose of purchasing annuities at future dates.

**Surrender Charges**

Two of the most important annuity features to evaluate are the surrender terms and surrender charges. Even when exchanging an annuity via Section 1035 of IRS code, it is possible for an annuity to impose surrender charges. Most annuities permit the owner to withdraw up to 10% of the funds per year, without penalty.

**Impact on Principal**

Surrender charges are typically higher in the earliest years after purchase and decline as time passes. The imposition of surrender charges may actually deplete principal. For example, surrender terms and fees might be:
- 7% penalty for funds withdrawn in the first year,
- 6% penalty for funds withdrawn in the second year,
- 5% penalty for funds withdrawn in the third year,
- 4% penalty for funds withdrawn in the fourth year,
- 3% penalty for funds withdrawn in the fifth year,
- 2% penalty for funds withdrawn in the sixth year,
- 1% penalty for funds withdrawn in the seventh year,
- No penalty for funds withdrawn after the seventh year

The purpose of surrender fees is to permit the insurance company to recoup expenses (mostly commissions) incurred to set up the annuity contract and to discourage buyers from using deferred annuities as short-term investments. Surrender terms typically involve seven years but some contracts impose them for as few as five years or as many as twenty years.

It should be noted that different types of annuities might also contain other surrender charges. For example, if the annuity is a two-tiered annuity, different surrender charges exist depending upon whether a lump sum is taken at retirement or the funds are annuitized. If the annuity involves any “bonus” amounts, the consumer’s entitlement to those amounts is contingent upon the funds remaining in the annuity for a specified amount of time; early withdrawal of funds or surrender of the contract imposes additional penalties and/or loss of interest.

**Annual Surrender Charge Exception**

Most annuities offer several exceptions to the surrender charge. The most common
exception to the surrender charge is the right for the contract owner to withdraw up to 10% of the contract value (or accumulated value) per year after the first contract anniversary. When this surrender charge exception is present it is almost always non-cumulative which means that if the owner does not take the allowed withdrawal in a given year it does not accumulate to be withdrawn later (use it or lose it).

**SURRENDER CHARGE WAIVERS**

Other waivers to surrender terms and charges exist; requirements vary by state and insurance company. For example, if a consumer must surrender her annuity because she is permanently confined to a nursing home, the contract will waive the surrender charges if she purchased a nursing home waiver. Examples of such waivers include:

- Nursing home waiver
- Extended care waiver
- Death waiver
- Terminal illness waiver
- Disability waiver

Many annuities completely waive the surrender charge if the annuitant dies, especially if the beneficiary is a surviving spouse. Other contracts will only waive the surrender charges if the beneficiary takes the annuity proceeds over a 5-year period.

The more waivers provided by an annuity contract, and the more generously worded they appear, the less restrictive the surrender terms and charges are viewed. However, if the consumer needs access to funds during the surrender charge period and his withdrawal does not comply with the requirements of one or more of the waivers, he will experience shrinkage of annuity values due to surrender charges.

**MARKET VALUE ADJUSTMENT (MVA)**

Annuities with a market value adjustment are often called CD-type annuities because they offer an interest guarantee for a multi-year period. *They are not CDs, however, and are not sold by banks nor are they FDIC insured.* A market value adjustment (MVA) can be found in a traditional fixed annuity or in an indexed annuity. The market value adjustment is a mechanism that “adjusts” the annuity value to reflect current economic conditions affecting the value of the insurance company’s invested assets when funds are withdrawn from the annuity.

The market value adjustment can be very confusing to most people and can result in a positive or a negative adjustment to the annuity contract value. There is a limit to the amount of a negative adjustment allowed; according to state law, it cannot reduce the annuity below minimum guaranteed values. This restriction is necessary to maintain the insurance status of the annuity by limiting the consumer’s exposure to investment risk. The annuity owner is subject to some investment risk when a market value adjustment is present in an annuity.

How does the market value adjustment work? Whether the market value adjustment is
positive (money is added to the annuity) or negative (money is subtracted from the annuity) depends upon the interest rates in the market—are they higher or lower than when the annuity was purchased? If current interest rates are higher than when the annuity was purchased, the adjustment is negative (money is taken away). Similarly, if current interest rates are lower than when the annuity was purchased, the adjustment is positive (money is added).

For example, assume the annuity is purchased when the interest rate is 6%. During the next year, the current interest rates drop to 4%. If funds were withdrawn from the annuity before the market value adjustment period expires, the MVA would be positive. That is, money would be added to the withdrawn funds because interest rates were lower than when the annuity was purchased. It should be noted that the market value adjustment is applied in addition to a surrender charge; if a withdrawal is taken during the surrender charge period, there will be a market value adjustment (positive or negative) applied in addition to a surrender charge.

With most market value adjustments, the interest rate guarantee period and the market value adjustment period expire at the same time. However, some annuities will have a market value adjustment period that runs longer. When a market value adjustment is present in an annuity, it requires considerable disclosure and explanation for the consumer to understand it fully.

**Surrender Charge Summary**

Contractual surrender terms and fees are separate from those required for the withdrawal of funds from an annuity prior to age 59 ½ and imposed in addition to the 10% federal penalty. For example, a 50 year-old consumer has $100,000 in his qualified fixed annuity and decides to surrender it in year two to replace his income because he lost his job. Using the surrender charges illustrated at the beginning of this chapter, he will be charged a 6% penalty PLUS the 10% penalty for withdrawing funds prior to age 59 ½. In addition, the funds will be subject to ordinary income tax. Depending upon his income tax bracket, the consumer could lose more than fifty percent of his money (both interest and principal) to taxes and surrender charge penalties.

If any surrender charges and fees apply at any point during the term of the annuity contract, the annuity disclosure form should clearly state either specific dollar amounts or actual percentages and explain how they apply. A variable annuity disclosure (since the product is a securities product) is required to contain more details of fees and/or charges than fixed annuity or equity indexed annuity disclosures. An example showing this difference involves premium taxes.

The variable annuity will disclose the premium taxes while the fixed annuity generally will not. The fixed annuity disclosure is not attempting to hide the premium tax—the tax is included in the cost structure of the fixed annuity and affects the guarantees of the product, therefore, it is not readily apparent. On the other hand, it would not be fair to state that the variable annuity has a charge for premium taxes and the fixed annuity does not. While the charge for premium taxes is not disclosed separately in the fixed annuity,
it is part of the product’s overall costs. Producers should understand this difference (and other differences) and be able to explain them in a fair, understandable manner.

Revealing to the consumer that the purchase of an annuity is designed to be a long-term venture, and should not address short-term goals, is essential. Failure of the producer to disclose these facts is both unethical and illegal. Failure on the part of the consumer to understand these facts may lead to undesirable taxable events and the loss of principal.

The following information concerning annuity contract benefits and features is typically contained in an annuity disclosure form and should be reviewed with the applicant, along with an offering by the producer to the consumer of pertinent examples and consequences for each element in the contract:

- The guaranteed, non-guaranteed, and determinable elements of the contract—along with their limitations and how those limitations operate
- The initial crediting interest rate of the annuity, including any bonus or introductory interest rates, the duration of such rates, and the fact that interest rates may change in the future and are not guaranteed
- Guaranteed and non-guaranteed periodic options
- Value reductions caused by withdrawals from, or surrender of, the annuity
- How contract values may be accessed by the consumer
- Any available death benefits and the method of their calculation
- A summary of the federal tax status pertinent to the contract and any applicable tax penalties for withdrawal from the contract
- Impact of any rider, specifically a long-term care rider

Every life insurance and annuity policy contains a provision stating that the owner of the policy or annuity may return it for cancellation and a full refund within a certain period of time. Return of the policy for cancellation must be made either through the mail to the insurance company or directly to the agent from whom it was purchased. The Free Look period can be no less than 10 days and no more than 30 days. The Free Look period is 30 days when replacement of an annuity contract is involved or if an annuity is sold to a senior aged 60 or older. Each policy delivered to an individual aged 60 or older must contain the Free Look notice in a font no smaller than uppercase 10-point type on the cover page of the policy and on the outline of coverage.

All individual annuity contracts, except variable annuities, that are delivered or issued for delivery in the state of California must have the following notice printed on the policy cover page, policy jacket, or on a sticker that has been affixed to the policy cover page or jacket, in 12-point bold-faced type:

"Important: You have purchased a life insurance policy or annuity contract. Carefully review it for limitations. This policy may be returned within 30 days from the date you received it for a full refund by returning it to the insurance company or agent who sold you the policy. After 30 days, cancellation may result in a substantial penalty, known as a surrender charge."

If the policy does not contain cancellation penalties or charges, the last sentence may be omitted from the notice.

All individual variable annuity contracts require a notice, subject to the same terms as
stated in the previous introductory paragraph, that states:
"Important: You have purchased a variable annuity contract (variable life insurance contract, or modified guaranteed contract). Carefully review it for limitations. This policy may be returned within 30 days from the date you received it. During that 30-day period, your money will be placed in a fixed account money-market fund, unless you direct that the premium be invested in a stock or bond portfolio underlying the contract during the 30-day period. If you do not direct that the premium be invested in a stock or bond portfolio, and if you return the policy within the 30-day period, you will be entitled to a refund of the premium and policy fees. If you direct that the premium be invested in a stock or bond portfolio during the 30-day period, and if you return the policy during that period, you will be entitled to a refund of the policy’s account value on the day the policy is received by the insurance company or agent who sold you this policy, which could be less than the premium you paid for the policy. A return of the policy after 30 days may result in a substantial penalty, known as a surrender charge.”

If the policy does not contain surrender charges, the last sentence may be omitted from the notice.

Return of the annuity contract for cancellation within the Free Look period requires the insurance company to void the policy from its inception so that the parties to the contract are in the same position as if no policy had been issued OR to refund the full contract value to the consumer.

**POLICY ADMINISTRATION CHARGES AND FEES**

Annuity contracts offer a variety of features and benefits, most of which involve fees. In addition, some annuity contracts (such as variable contracts) involve inherent expenses, charges, and fees for a number of things.

- **Mortality and expense risk charge** – (variable annuities) – This charge compensates the insurance company for the insurance risks it assumes when issuing the annuity contract. It is usually in the vicinity of 1.25% of the annuity account value, per year.
- **Administrative fees** – This charge compensates the insurance company for record keeping and administration fees. Sometimes it is a flat fee, such as $25 or $35 per year, or a percentage of the annuity account value—usually in the vicinity of .15% per year.
- **Underlying fund expenses** – (variable annuities) – This charge compensates the insurance company for expenses imposed by the mutual funds in the underlying investment accounts in the annuity.
- **Other features** – These charges are incurred for the purchase of additional annuity features, such as a stepped-up death benefit, long-term care insurance, and other guaranteed benefits.
INCOME DISTRIBUTIONS

**SPLIT ANNUITY**

A split annuity is actually two annuities. The consumer makes a single, lump sum payment to fund two different types of annuities: an immediate annuity for the purpose of generating monthly income and a deferred annuity for the purpose of accumulating funds at interest.

This investment strategy is especially effective for retirees concerned with the prospect of outliving their retirement funds or who have fixed expenses that are not expected to disappear. For example, Bert retires at age sixty-five and purchases a split annuity. The immediate annuity instantly begins replacing the income he earned when working and the deferred annuity accumulates at interest. Ideally, the deferred annuity will be restored to the initial principal amount by the time the annuity payments provided paid by the immediate annuity are depleted. Another example would be that Bert, when he retires, suffers only a partial income reduction because his employee pension kicks in. He does, however, have a large mortgage payment for the next seven years. The monthly income generated by the immediate annuity can be used to make the monthly mortgage payments. By the time the mortgage is paid off, the accumulation in the deferred annuity will have restored some of the principal used to establish the immediate annuity.

**ANNUITY SETTLEMENT OPTIONS**

When an owner decides to annuitize his annuity (begin taking distribution of the annuity values), several payout options exist, which include:

- **Life** – This option provides a guaranteed income for the lifetime of the owner or annuitant. When the annuitant dies, payments cease and do not continue to beneficiaries.

- **Joint and Survivor** – This option is provided when a Joint and Survivor annuity is purchased on the lives of two annuitants—usually a husband and wife. It provides a payout for as long as either of the two annuitants is alive. The amount of each payment is usually less than if it were based on a single annuitant. The annuitants may choose to have payments remain the same or decrease after the death of the first annuitant. For example, after the first annuitant dies, they may choose to have payments reduce to two-thirds of the amount paid while both annuitants were alive.

- **Period Certain** – This option provides payments that are guaranteed to continue for a specified time, regardless of how long the owner or annuitant lives. For example, the period certain may be five years or ten years; most companies offer periods ranging from five to thirty years. If the owner or annuitant dies before the period has expired, payments continue to the beneficiaries designated by the owner for the duration of the period certain. For example, if the owner chose a ten-year period certain and dies in year six, his beneficiaries will continue receiving payments for the next four years—until the ten-year period certain expires.

- **Cash Refunds** – Two types of annuity payouts are available if the owner purchases...
a refund feature. This feature reduces the amount of each monthly payment, but it does guarantee the principal value of the annuity. The Cash Refund Annuity allows for a lump sum refund of the premiums paid by the owner to the beneficiaries, minus the annuity payments already made, before the annuitant’s death. The Installment Refund Annuity allows for payment of installments to the beneficiaries until the total amount paid out to the annuitant before his death, and to his beneficiaries, equals the amount of premiums paid into the annuity.

- **Systematic Withdrawal Plan** – This option allows the owner to leave the assets in the annuity while the owner receives regular distributions until a) the contract values are exhausted, or b) the owner opts to suspend this plan. All earnings are distributed before the principal is distributed and are taxed as ordinary income. Assets left in the annuity continue to grow, tax-deferred. (This is not an annuitization option, but many contracts offer it as an alternative to annuitization; its advantage is that the owner maintains control of the annuity assets.)

**ADVANTAGES AND DISADVANTAGES OF ANNUITIZATION OPTIONS**

Because of the uncertainty of an individual’s longevity, making a decision about how to receive distribution of an annuity’s contract values presents much confusion and frustration for the typical consumer. Contract owners may choose one payout option or combine two options to generate the type and amount of retirement income needed.

Let’s say Donald is 65 years old, he just retired, and he’s married to Doris, who is 61 years old and still working. What type of income distributions should he take from his annuity?

If Donald elects to receive payments for life (a life annuity), he can’t outlive his income. This is a definite advantage. On the other hand, if he dies sooner rather than later, the insurance company will keep the rest of his money and Doris will get nothing—a big disadvantage. Yes, he can elect a cash refund feature, which will reduce the amount of his monthly payments, but Doris will receive some money when he dies—assuming his insurance company (and annuity contract) offers this feature.

Donald can elect a period certain payout distribution, which guarantees monthly payments to him for life, and to Doris, who is his sole beneficiary (also his surviving spouse when he dies), for a certain length of time if he dies within that period of time. Therefore, if he opts for a ten year certain period, and he dies within that ten-year period, Doris will continue to receive his payments for the duration of the ten years (this is a ten-year certain and life annuity).

Donald can also elect to receive a lump sum distribution. The advantage to this option is that Donald gets his entire principal back, along with its earnings. The biggest disadvantages are that he’ll no longer have a guaranteed income stream or access to the principal. In addition, he must pay taxes on the growth, right now. He can’t spread it out over the future, as he’d be able to if he took regular payments. The annuity’s taxed-deferred growth will now be taxed as ordinary income. Considering that Doris is still working, their combined taxable income will likely be higher than it would be if he
deferred distribution of the annuity.

**CONTRACT PROVISIONS COMMON TO FIXED ANNUITIES**

**Death Benefits**

Fixed annuity contracts do not provide guaranteed death benefits as life insurance policies do. They do, however, provide the beneficiary with the annuity’s contract value upon the death of the annuitant—if the annuity has not been annuitized prior to the annuitant’s death. If the annuity had already begun distributions to the owner before he died, the beneficiary will receive payments based on the payout option selected by the contract owner. Some contracts will offer a rider that guarantees a death benefit; this rider will incur a charge.

Beneficiaries must make one of the following elections when the annuitant dies:
- Take an immediate lump sum, or
- Compete all withdrawals within five years of the annuitant’s death, or
- Take annuitization over the life of the beneficiary to start within one year of the annuitant’s death; if a spouse is the sole beneficiary (or surviving owner), the spouse can also elect to continue the contract.

**Charges and Fees**

*Surrender Charges*

As previously discussed, all annuity contracts involve a surrender charge term and fees. Typically, if withdrawals are made in the early years of an annuity, the contract owner is penalized a percentage of the annuity’s contract values. As the annuity ages, the penalty percentage decreases. The most common surrender charge period is seven years, but some contracts impose surrender charges from five to twenty years. One thing to confirm is that the surrender charge period begins with the issue date of the annuity and NOT with the date of each new contribution.

*Fees*

Fixed annuities apply fees differently than variable annuities do. In a fixed annuity, the fees and costs are taken into account internally when the insurance company declares its interest rate, therefore, the consumer does not see them. The difference between what the insurance company expects to earn and what it commits to pay in interest is intended to cover the insurance company’s expenses.

**Interest Rate Strategies**

Depending upon the type of annuity, the insurance company issuing the contract will credit a rate of interest to the contract values. In fixed annuities, the insurance company takes the contributions and invests them; the insurance company earns a rate of interest on its investments and, after subtracting costs and fees, pays the contract owner a rate of interest. A minimum rate of interest is always guaranteed in a fixed annuity. In addition, the annuity contract guarantees interest for periods of one or more years.
Annual
Fixed annuities usually guarantee payment of the current rate of interest for one policy year, beginning with the contract’s issue date. At the next and subsequent anniversary dates, the insurance company will declare a new interest rate, which cannot be less than the interest rate guaranteed in the contract (currently around 3% - 4%). The guaranteed interest rate in a fixed annuity contract is called the “floor rate.”

Multi-Year
Multiple year guaranteed interest annuities (MYGIA) will lock interest rates in for two, three, or more years, usually capping the guarantee period at ten years. Some people refer to these as “CD-style” annuities because you can lock the rate in for several years; however, it should be clearly stated that these annuities are not issued by a bank, not insured by the FDIC, and a significant loss of interest can be suffered if premature withdrawals are made.

INTEREST RATE CREDITING METHODS

Portfolio Rates
Insurance companies invest their annuity funds in a portfolio of investments, typically in bonds. As a result, their credited rate of interest during the first year of an annuity contract, and each subsequent renewal year, is based on their best estimate of the investment return they hope to make during the coming year. Depending upon how the insurance company makes its investments, and the yield of the bonds in its portfolio, the portfolio interest rate will vary in renewal years. This is very similar to the method used by life insurance companies when calculating cash values in traditional whole life insurance policies.

New Money Rates
Some insurance companies credit interest at different rates depending upon when the contributions were made. For example, the “new money” will be comprised of contributions made in the current year. All previous contributions are considered old money. The insurance company allocates the funds into two buckets—the old money bucket and the “new money” bucket. The interest rate credited on the old money is usually less than that which is credited on the new money. Calculating the final return in this type of contract can be difficult unless one is very familiar with the formulas used. Quite often, the total return on the annuity will be less than the return a consumer could have obtained if purchasing a contract that credited interest at the portfolio rate.

For example, let’s say Insurance Company A currently offers an interest rate of 5% and it fluctuates from year to year, but always pays more than the minimum guarantee, or floor rate. Insurance Company B offers a “new money” rate of 6% and an old money rate of 3%. In the long run, the contract issued by Insurance Company A will realize greater growth than the contract issued by Insurance Company B.

First Year Bonus “Teaser” Rates
Some insurance companies offer incentive programs to induce consumers to purchase
annuity contracts. The programs offer higher rates of interest during the first year, or first few years, of the fixed annuity contract and depend upon certain criteria, including age of the annuitant, whether the contract is qualified or non-qualified, whether premiums are flexible or lump sum, etc. Bonus rates may be very attractive at first glance but, upon closer inspection, might not look quite so good.

Bonus interest rates can significantly supplement the initial return on principal, which contributes to their appeal. Sometimes, however, the insurance company bases the promise of a bonus on the expectation that the consumer will keep the annuity for ten years. If the consumer surrenders the annuity before that time period is up, not only is the bonus interest rate forfeited, surrender charges are imposed which significantly decrease the consumer’s annuity values and, sometimes, even the principal.

It should also be noted that most annuities offering bonus interest rates charge higher fees than contracts not offering bonus interest rates and generally have longer surrender periods.

**Minimum Guaranteed Interest Rates—California**

It is important for a producer to explain to a consumer that the lower the credited interest rate on his annuity, the less income generating potential exists in the contract and the higher the remainder interest is. Because of the current market volatility and low interest rate environment, opportunities exist for unethical producers to explain incorrectly the workings of variable and equity-indexed annuities to make them appear more attractive as investment vehicles.

According to Christopher D. Perry, the senior fiduciary officer at Northern Trust Bank in Boston, and a former attorney, “Each month the Internal Revenue Service (IRS) announces the interest rate used to measure the present value of annuities, income interests, and remainder interests for gift tax purposes. That interest rate is known as the “Section 7520 rate,” and is named after the section of the Internal Revenue Code that defines it. The Section 7520 rate now is near its historic low. In June 1989, the Section 7520 rate was at a historical high of 11.6%; in July 2003, it was at a historical low of 3%. In May 2008, it was back at 3.2%. And in September 2008, it was at 4.2%.” The Section 7520 rate was 3.2% in December 2009. During the first half of 2009 in ranged from 2.5% in January to 2.8% in June, with the lowest rate being 2% in February. It jumped to 3.4% in July and remained steady until October, when it dropped slightly to 3.2%.

Because the purpose of California Insurance Code is to protect consumers, CIC has established minimum guaranteed interest rates on annuities. The minimum guaranteed interest rate is the lesser of 3% and the following:

- The five-year Constant Maturity Treasury Rate reported by the Federal Reserve on a particular date, or averaged over a period, rounded to the nearest one-twentieth of 1 percent, specified in the contract no longer than 15 months prior to the contract issue date or redetermination date under paragraph (2), reduced by 125 basis points, where the resulting rate is not less than 1 percent.
The interest rate must apply for the initial period and may be re-determined for future periods. Any re-determination period, including dates and basis, must be stated in the annuity contract.

The minimum values specified in CIC, for any paid-up annuity, cash surrender, or death benefits available under an annuity contract, will be based upon minimum non-forfeiture amounts as follows:

- The minimum non-forfeiture amount at, or prior to, annuitization will be the account value at the minimum guaranteed interest rate as described in the previous paragraph, minus the following:
  - Prior withdrawals or partial surrenders
  - An annual contract charge of $50
  - Any state premium tax paid by the insurance company for the contract that is not later credited back to the insurance company
  - The amount of any indebtedness to the insurance company, including interest

- The net considerations for a given contract year used to define the minimum non-forfeiture amount will be an amount equal to 87.5% of the gross considerations credited to the contract during that contract year.

- During the period or term that a contract provides substantive participation in an equity indexed benefit, it may increase the reduction described above by up to an additional 100 basis points to reflect the value of the equity index benefit. The present value at the contract issue date, and at each re-determination date thereafter, of the additional reduction will not exceed the market value of the benefit. The commissioner may require a demonstration that the present value of the additional reduction does not exceed the market value of the benefit. Lacking a demonstration that is acceptable to the commissioner, the commissioner may disallow or limit the additional reduction.

**CONTRACT PROVISIONS COMMON TO VARIABLE ANNUITIES**

**SALES AND LICENSING REQUIREMENTS OF VARIABLE ANNUITIES**

Variable annuities are considered to be both life insurance products and securities products. As such, they are subject to insurance AND securities regulation, both at the state level and by the Securities and Exchange Commission (SEC). The only individuals who may sell variable annuities are life insurance producers who also hold securities licenses. The sale of a variable annuity must always be accompanied by the delivery of a prospectus to the applicant. A prospectus is a legal document that insurance companies must, per requirements of the SEC, provide to individuals who are buying, or considering the purchase of, a variable annuity. It contains material information about the variable annuity, including facts about the underlying investments, a description of the insurance company’s business, financial statements and ratings, officers and directors (including details of their compensation), any pending or current litigation, etc.
FINRA, The Financial Industry Regulatory Authority, is the non-governmental regulator for all securities firms doing business in the United States and it serves as the federal level regulator for variable annuity sales. FINRA was created in July 2007 when the National Association of Securities Dealers (NASD) consolidated with the member regulation, enforcement and arbitration functions of the New York Stock Exchange (NYSE).

Variable annuities have evolved into sophisticated securities vehicles with a combination of security and insurance features. For a number of years, regulators have been concerned about the suitability of some variable annuity sales in the face of growing product complexity. FINRA has published Rule 2821 that deals with variable annuities. Several sections of this rule became effective May 5, 2008 and, as of this writing, implementation of the deadline for compliance with other sections has been postponed until February 2010.

FINRA adopted Rule 2821 in response to its perception of “numerous instances of questionable sales practices” and inadequate supervision and training procedures regarding variable annuities. Rule 2821 is focused on four main areas related to variable annuities:

- Suitability
- Principal review and approval
- Supervisory procedures
- Training

In a variable annuity, the annuity values are tied to the value of the securities selected within the annuity. Most variable annuities offer a range of investment options within each annuity, called subaccounts; the investments range from conservative to aggressive and are similar to mutual funds. The variable annuity contract owner has the option of spreading his annuity values over several subaccounts. It is common for variable annuities to offer portfolio allocation models designed to automatically balance the investment accounts, based on the goals of the model, as the values fluctuate by transferring amounts among subaccounts to “rebalance” the annuity subaccounts. Variable annuities usually also offer a fixed income account which guarantees a minimum rate of return.

The primary use of variable annuities is to permit an investor to engage in tax-deferred retirement investing of amounts that exceed the contribution limits allowed in IRAs and 401(k)s. Many variable annuities also offer a guaranteed minimum rate of return even if the underlying account(s) perform poorly.

Because variable annuities carry higher risks than fixed annuities, it is important to understand how the annuity principal has the potential of growing. Like the investment account in a fixed annuity, a variable annuity contains a general account that offers a guaranteed minimum rate of interest, usually for a year at a time. All other accounts in a variable annuity are legally segregated from the insurance company’s general account and its creditors, and are called separate accounts.
The separate accounts are considered securities because they hold securities in a pooled form in a fashion similar to mutual funds. Separate accounts are regulated by the SEC and must also be registered under the Investment Company Act of 1940 because of their similarity to mutual funds. The different types of account options include a fixed account, stocks, bonds, mutual funds, and a variety of short-term investments.

The different subaccounts may increase or decrease in value, depending upon their market performance. A consumer may invest in one or more subaccounts without incurring additional costs or transaction fees. Many insurance companies offer a guaranteed death benefit option that guarantees the investor’s original investment.

Variable annuities can be either equity-based or risk-based. The previous discussions involved risk-based variable annuities. Equity-based variable annuities are very complex and contain characteristics of fixed annuities. They offer a minimum guaranteed rate of interest combined with an interest rate that is calculated by applying a formula to an external financial index such as the Standard & Poor’s 500®, the Dow Jones Industrial Average®, or the Lehman Aggregate Bond Index®. The formula used to calculate the current credited interest can vary from product to product. It is also possible to have different portions of the annuity values indexed using different indices and formulas.

An Equity-based annuity involves less market risk, and potential for earnings, than a straight risk-based variable annuity but it offers the potential for greater returns than a traditional fixed annuity.

**CHARGES AND FEES**

A variable annuity contains more charges and fees than a fixed annuity does because of its status as a securities product. Many of the charges and fees pertain to the underlying investment accounts and optional riders that are available, such as:

- Annual insurance charge – approximately 1.25% per year
- Annual investment management fees – ranging from .5% - 2%+ per year
- Charges for riders
- Surrender fees

These fees can have a significant impact on the growth of the annuity values. Therefore, it is very important for the consumer to read the prospectus, which is required by the SEC to disclose all fees and charges related to the variable annuity.

**DOLLAR COST AVERAGING**

Dollar cost averaging is an investment strategy involving the systematic transfer of premiums, generally from the fixed account of a variable annuity or its money market option, to a stock fund over a period time. Timing is the most important element of this strategy. The goal to be achieved is purchasing fewer shares when prices are high and purchasing more shares when prices are low—especially when investors are concerned about investing when the market is at a peak. This strategy results in the total average cost per share of the investment being less than if a single purchase had been made.
For example, a consumer may want to invest in a particular stock fund, however, if a large allocation to the fund is made at one time—when the values of the stock fund are quite high—the single purchase price could be locked in. Dollar cost averaging does not guarantee a profit, nor does it protect against loss, but it is a way to accomplish investment goals effectively.

**DEATH BENEFIT GUARANTEES**

Variable annuities have traditionally offered a guaranteed death benefit if the annuitant or contract owner dies during the accumulation period of a deferred annuity. The Guaranteed Minimum Death Benefit (GMDB) offers downside market protection at death. In its original form, the GMDB promised that if the variable annuity owner or annuitant died, the beneficiary would be guaranteed the greater of the account value at death or a return of principal. This basic GMDB covers markets risks associated with equity investing but only did so if the owner or annuitant died. It should be noted that a GMDB does not protect the owner from market risks, but does protect the beneficiaries from it.

Some insurance companies have enhanced the basic GMDB by stipulating that, in addition to guaranteeing the return of either the principal or account value at death, they would add an enhanced death benefit. At the end of 2008, it was reported by Insured Retirement Institute (IRI) that 87% of variable annuity contracts offered some form of enhanced death benefit.

**Initial Purchase Payment with Interest (or Rising Floor) GMDB**

At the end of 2008, approximately 47% of variable annuity contracts offered this benefit in some form. The benefit guarantees the great of the contract value at death or the total of all premium payments made, minus withdrawals. A specified rate of interest is applied. The cost of this benefit ranges from 5 to 135 basis points annually.

**Anniversary Ratchet GMDB**

At the end of 2008, approximately 80% of variable annuity contracts offered this benefit in some form. It is a form of benefit that increases based upon preset criteria and guarantees the greater of:

- The contract value at death, or
- The total of premium payments minus any withdrawals, or
- The contract value on the specified, preset, date

The prior, preset date is usually an anniversary date—every year, every other year, or even as infrequently as every seven years. A ratchet GMDB locks in the annuity contract’s growth on each of the preset dates. The cost of this benefit ranges from 5-115 basis points annually.

**Enhanced Earnings Benefits**

At the end of 2008, approximately 64% of variable annuity contracts offered this benefit in some form. This benefit is fairly new and does not protect against falling markets.
Instead, it offers enhanced earnings benefits (EEBs) that provide a separate death benefit to help offset federal income taxes due and payable at the death of the contract owner or annuitant. This benefit offers beneficiaries not only the guaranteed death benefit amount but also an additional amount equal to a percentage of the variable annuity’s earnings at death, for example 40%. The cost of this benefit ranges from 10-95 basis points.

**Living Benefit Guarantees**

When variable annuities were new, and until only recently, the only guarantee of principal was offered when the contract owner or annuitant died. Insurance companies now offer living protection against investment risk by offering guarantees for a variety of different benefits. According to IRI, 71% of variable annuity contracts offer some form of living benefit rider.

Guaranteed minimum living benefit (GMLB) riders are usually offered with new contracts but some insurance companies will allow them to be added to existing contracts. The costs for these benefits are assessed as a percentage of the contract value.

- **Guaranteed Minimum Income Benefit** (GMIB) – allows a guaranteed minimum value of payments (only available if the annuity is annuitized) regardless of how the investments have performed. The guarantee is based on the greater of the amount invested at a preset rate of interest (usually 3-6%) or the maximum anniversary value of the account prior to annuitization. This benefit usually involves a 7-10 year holding period before it can be exercised and age limits may apply.

- **Guaranteed Minimum Accumulation Benefit** (GMAB) – allows a guaranteed minimum amount after the accumulation period or a set period of time (protects the annuity value) regardless of how the investments have performed. The guarantee is equal to at least a minimum percentage of the amount invested (usually 100%) after a preset number of years (usually 7-10). Oftentimes, this type of benefit calls for some sort of asset allocation.

- **Guaranteed Minimum Withdrawal Benefit** – allows minimum withdrawals from the annuity without having to annuitize the contract for the purpose of recovering the amount of the account, regardless of how the investments have performed. The annual withdrawal amount is a percentage of the amount invested (usually 5-7%). If the underlying investments perform well, an excess amount will be contained in the fund at the end of the withdrawal period. If the underlying investments perform poorly, and the account value is depleted by the end of the withdrawal period, the consumer is permitted to continue to make withdrawals until the full amount of the amount invested is recovered.

- **Guaranteed Lifetime Withdrawal Benefit** – allows minimum withdrawals from the annuity without having to annuitize the contract (avoids annuitization and penalties). The guarantee allows that a specified percentage of the amount invested in the annuity (usually 2-8%, depending upon age) may be withdrawn each year, for as long as the contract owner lives, without penalty.
**CONTRACT PROVISIONS COMMON TO INDEXED ANNUITIES**

An indexed annuity is a type of fixed annuity contract that was first marketed in the mid 1990’s. Indexed annuities have accounted for a large portion of annuity sales since being introduced. Several differences exist between indexed annuities and traditional fixed annuities, most notably the way current interest credits are calculated and what portion of the principal is guaranteed. Most indexed annuities offer a declared interest rate as an option for the consumer. This interest crediting is handled in the same fashion as in the traditional fixed annuity described above.

The first of these differences accounts for much of the consumer acceptance of the indexed annuities. The current interest on this type of contract is calculated by applying a formula to an external financial index such as the Standard & Poor’s 500® (which bases its figures on the 500 stocks that are intended to be representative of a broad segment of the market), the Dow Jones Industrial Average®, or the Lehman Aggregate Bond Index®. The formula used to calculate the current credited interest can vary from product to product. It is possible to have different portions of the annuity values indexed using different indices and formulas.

PLEASE NOTE: The term *indexing method*, as used in this text, means the formula for calculating current credited interest. It is imperative for the producer to explain to the consumer the different indices available and how they work, as well as to ascertain that the consumer has a clear understanding of the differences between the indexed annuity contract and the other types of annuity contracts available.

**PRIMARY INTEREST CREDITING STRATEGIES**

*Monthly Averaging*

The beginning value for the indexing calculation is the actual value of the index on the policy inception date. The ending value will be the average of actual values of the index measured periodically—with monthly and daily averaging being the most common. Averaging may reduce the amount of index-linked interest earned by the consumer.

For example, if the policy year began on February 8th and the annuity used monthly averaging, the beginning value for the calculation would be the actual value of the index on February 8th. The ending value for the calculation would be the average of the twelve actual values of the index measured on the 8th of each month through the February 8th of the following year.

*Point to Point*

With point to point indexing, the change in the index value is measured based on two points in time. It is usually calculated on an annual basis at the policy anniversary but it can be calculated on long-term basis. The change in the actual index value from the start point to the end point is expressed as a percentage. For example, if the index value were 500 at the start point and 550 at the end point, there would have been a 10% increase in the index during the policy year. On the other hand, if a sudden decline occurred on the end date, then all or part of the previous gain could be lost.
The advantage of point to point indexing is that it may be combined with other features, such as cap and participation rates (to be discussed shortly), that may credit the consumer with more interest. The disadvantage, as previously stated, is that it calculates interest based on specific points in time and previous gains may be lost, depending upon the actual index values at the end point in time.

**Annual Reset**

When utilizing annual point to point indexing, many annuity contracts have an annual reset provision that automatically sets the beginning index value for the ensuing year’s calculation to the ending value of the index from the current year. The previous years’ index performance does not affect the account’s performance in future years. The annual reset has the effect of making the ending value (at the end of the contract year) of the chosen index the beginning value for the ensuing year’s calculation. Quite often, an annuity utilizing an annual reset may actually credit more interest than annuities using other methods when the index rises and falls between the interest-calculating begin and end points. The annual reset provision also permits a locked-in index credit to be added to the index account on every anniversary. In the absence of the annual reset provision, index linked interest could not be credited to the annuity until the index returned to a level higher than the original starting point.

**High Water Mark**

This method of indexing looks at the index value at various points during the contract, usually annual anniversaries. Then, it selects the highest of these values and compares it to the index level at the start of the high water mark term.

The advantage of high water mark indexing is that it may credit the consumer with more interest than other indexing methods and may also protect against declines. The disadvantage is the possibility of not receiving any index-linked gain if the contract is prematurely surrendered. This indexing method may also be combined with other methods, such as cap and participation rates (to be discussed shortly), that may limit the consumer’s gain.

**Participation Rates**

Most indexed annuities include a participation rate as part of their formula for determining current credited interest. The participation rate determines what percentage of the increase in the index will be used to calculate interest credited to the contract for the year.

For example, if the calculated change in the index is 9% and the participation rate is 70%, the index-linked interest rate for the annuity will be 6.3% (.09 x .7 = 6.3%). In most indexed annuities that have a participation rate included as part of the crediting formula, the participation rate can be changed by the insurance company. Contracts usually contain a guarantee stating the lowest participation rate to be set by the insurance company (usually 30%). Once the participation rate is set, it cannot be changed until the next indexing term.
**Cap Rates**

Most indexed annuity contracts include an upper limit, or cap, on the index-calculated interest rate and state it as a percentage, such as 6%. This is the maximum rate of interest the annuity will earn, regardless of the gains in the index. For example, if the contract has a 6% cap and the annuity gained 9%, the gain in the annuity would be credited at 6%.

**Spreads**

Some indexed annuities use a spread, margin, or asset fee approach instead of a participation rate—or in addition to it, and state it as a percentage. This spread will be deducted from any index-linked gain credited to the annuity.

For example, if the calculated change in the index is 8%, the annuity might specify that the spread/margin/asset fee of 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 5.75% (.08 - .0225 = 5.75%). The insurance company subtracts the percentage only if the change in the index produces a positive interest rate. Equity index annuities that impose a spread, margin, or administrative fee rarely have an interest cap.

**Minimum Guaranteed Interest Rates**

Because an indexed annuity is a type of fixed annuity, it contains a minimum guaranteed interest rate. Typically, the minimum guaranteed interest rate is 3%. Sometimes, this is minimum guaranteed rate is linked to a minimum guaranteed return, which represents 90% of all premiums paid, credited with 3% interest.

**Caution About Participation Rates, Cap Rates, and Spreads**

Some indexed annuity contracts permit the insurance company to change participation rates, cap rates, or spreads—either at the beginning of the next contract year or annually. If an insurance company lowers the participation/cap rates, or increases the spread, the consumer’s investment return can be unfavorably affected. It is imperative for both the producer and the consumer to review the contract in this regards.

**Premature Surrender Charges**

All of the interest crediting methods previously discussed will be negatively affected by the premature surrender of the indexed annuity contract. The interest crediting methods that involve a precise time span in the calculation of interest to be credited usually result in no interest being credited during the time span in which the surrender is made. Some indexed annuity contracts pay NO index-linked interest at all if the contract is surrendered prematurely. Other contract penalties or surrender charges will be imposed in addition to the loss of interest.

Most indexed annuity contracts permit the contract owner to change his interest calculation methods on an annual basis tied to the contract’s anniversary. If the contract
owner suspects that he’ll soon need to make a withdrawal from his contract values, he should change the interest calculation method to fixed at the earliest opportunity.

**CHARGES AND FEES**

Because the indexed annuity is a fixed annuity, it contains fewer charges and fees than a variable annuity. The charges and fees included in an indexed annuity contract include:

- Spread/margin/asset fee – represented as a percentage of contract value
- The inherent fees of a fixed annuity, as previously discussed
- Contract surrender fees

**ANNUITY RIDERS**

**LONGEVITY AND LIFE INSURANCE RIDERS**

Because people are living longer and concerns about outliving one’s income abound, some insurance companies are offering a rider to insure against the risks of longevity. The insurance companies that offer this rider believe longevity is a risk that can be pooled, as life insurance risks are pooled.

This rider provides guaranteed future income beginning at a high age, such as 85, to those annuitants who are still living when they reach the specified age. The annuitants who die before they reach age 85 finance the income paid to those who live to age 85 and collect the rider benefits. Roughly 10% of the contract owner’s funds are invested in an annuity to fund the after-age 85 income stream and the remaining 90% is used to fund retirement needs prior to age 85. Not all insurance companies are offering this rider because of concerns about adverse selection and delayed-gratification.

Most annuity contracts offer a death benefit that is payable to the designated beneficiary when the annuitant dies. For a fee, a life insurance rider may be purchased that provides additional death benefits, such as doubling the original investment or stepping up the death benefit so it equals the contract value.

**LONG-TERM CARE RIDERS**

Long-term care riders pay living benefits when a serious medical condition arises—such as a heart attack, stroke, or cancer—even if confinement to a nursing home does not occur. Some riders permit the contract owner to receive up to half the contract’s values in a lump sum, rather than in periodic payments.

Long-term care riders have limits—often provide nursing home care only after confinement in a hospital or skilled nursing facility. They also have exclusions, such as long-term care required as the result of alcoholism, drug addiction, or suicide attempts. It is essential for the producer to be familiar with, and disclose, all rider contingencies. Long-term care riders should not be sold as an alternative to long-term care insurance. Some riders require the policyholder to have made out-of-pocket payments for care for a
specific period of time before the rider makes payment.

Long-term care riders are NOT the same as crisis waivers, which waive surrender fees if the contract owner should make withdrawals because of a medical crisis--confinement to a nursing home, for example.

### Loan Provisions

Some annuity contracts permit the contract owner to take a loan against the contract values. Because of state and federal regulations that concern the maximum rate of interest that may be charged, repayment terms, and the stricter requirements of a qualified annuity, taking a loan against an annuity is not usually recommended.
CHAPTER 5 – REVIEW QUESTIONS

Answers are in the back of the text

1. Most insurance companies require maximum issue ages of annuitants and owners based upon _____.
   [a] Insurance company underwriting guidelines
   [b] California Insurance Code
   [c] Life expectancy tables and minimum required distribution limits
   [d] Age of the beneficiary

2. All of the following are examples of annuity contract charges and fees EXCEPT _____.
   [a] Mortality and expense risk charge
   [b] Administrative fees
   [c] Underlying fund expense fees
   [d] Late payment charge

3. The credited rate of interest being based on the insurance company’s best estimate of the investment return they hope to make during the coming year best describes _____.
   [a] Portfolio rate
   [b] Bonus rate
   [c] New money rate
   [d] Minimum guaranteed rate

4. Point to point indexing is _____.
   [a] The actual value of the index on the policy inception date
   [b] The same as monthly averaging
   [c] Included in a participation rate
   [d] The change in the index value is measured based on two specific points in time

5. A longevity rider _____.
   [a] Is the same as a long-term care rider
   [b] Provides guaranteed future income beginning at a high age, such as 85
   [c] Is offered by every life insurance company
   [d] Guarantees a retirement income before the annuitant’s age 85
Chapter 6

Qualified Plans and Annuities

QUALIFIED VERSUS NON-QUALIFIED

In addition to classifying annuities based on the investment type, when benefits are paid, and how and when premiums are paid, a further distinction is made with respect to the tax status of the funds contributed into the annuity.

A **qualified annuity** is purchased with **pre-tax dollars**, meaning the contract owner receives an income tax deduction that equals the amount of contributions in a particular taxable year and all funds going into the annuity contract **are un-taxed**. When any type of distribution is taken from a qualified annuity, the entire distribution is taxed as ordinary income to the recipient, based on his tax bracket at the time the distribution is received.

A **non-qualified annuity** is purchased with **after-tax dollars**, meaning the contract owner paid all income taxes prior to making his contribution into the annuity. The only portion of distributions taken from a non-qualified annuity that are taxable are the earnings; the premiums contributed into the annuity were already taxed prior to making the contribution and will not be taxed again.

Annuities may be used in qualified retirement plans, such as Individual Retirement Annuities (IRAs), pension plans, profit-sharing plans, 401(k) plans, 403(b) plans/Tax Sheltered Annuities (TSAs), and Simplified Employee Plans (SEPs).

**PENSION PLANS/DEFINED BENEFIT PLANS**

Pension plans, or defined benefit plans, generate a specific monthly payout (the defined benefit) to a retiree based on his individual salary history, years of service, and retirement age or as a precise dollar amount. The benefits in most traditional defined benefit plans are protected by federal insurance provided through the Pension Benefit Guaranty Corporation (PBGC). For example, the defined benefit plan can provide $200 per month at retirement for each employee or may utilize a formula such as 1% of the employee’s average salary during the last five years of employment for every year employed.

The funding for these plans comes from the employer (in private-sector defined benefit plans) and employees seldom contribute any of their own money; defined benefit plans are usually qualified plans. The payments to retirees are guaranteed, regardless of the performance of the plan’s underlying investments or the longevity of the retiree. If the underlying investments do not perform as expected, or if retirees live longer than expected, the employer may have to increase contributions to the plan—bearing both the
investment and longevity risks. Payments under these plans usually begin at retirement. Since the consumer does not usually contribute to defined benefit plans, they are a welcome source of retirement income, however, they are taxable as ordinary income. Unfortunately, the consumer has no control over the existence of such a plan or its permanence.

**DEFINED CONTRIBUTION PLANS**

Unlike defined benefit plans, defined contribution plans do not guarantee a specific payout amount at retirement. The amount contributed into the plan is defined, but the ultimate benefit is not. For example, an employee may contribute up to 5% of annual earnings and the employer will match 2% of annual earnings.

The monthly benefit received at retirement will be determined based on a number of factors: the amount of money contributed into the account by the employer, the amount of money contributed into the account by the employee, the rate of investment growth, and the length of time the assets remain in the account (determined by the employee’s age at retirement).

Investment decisions are usually made by the employee, who bears both the investment and longevity risks. Types of defined contribution plans include 401(k) plans, Tax Sheltered Annuity/403(b) plans, employee stock ownership plans, and profit-sharing plans.

**INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)**

An Individual Retirement Account (also called Individual Retirement Arrangement or Individual Retirement Annuity) is a qualified retirement account that is usually established through a bank, mutual fund company, brokerage firm (for accounts), or life insurance company (for annuities). Individuals with IRAs are subject to certain contribution limitations each calendar year. For example, in 2009, individuals under the age of 50 could usually contribute up to $5,000, individuals aged 50, and older could contribute $6,000. Earnings on the contributions grown tax-deferred until they are withdrawn, at which time they are taxed as ordinary income—not as capital gains, which enjoy a lower tax rate.

Withdrawals made before the holder of the account reaches age 59 ½ incur a 10% federal tax penalty—unless he meets certain exceptions, which include withdrawals made:
- On account of the IRA owner’s death
- On account of the IRA owner’s disability
- On account of the IRA owner’s qualified first-time home purchase
- On account of the IRA owner’s substantially equal periodic payments over life expectancy
- Not in excess of the IRA owner’s qualified higher education expenses
- Not in excess of the IRA owner’s certain medical insurance premiums paid while unemployed
**Roth IRA**

A Roth IRA works in a similar fashion to a traditional IRA, except that it is not a qualified plan, meaning that contributions are made with after-tax dollars. The differences between a traditional, qualified, IRA and a non-qualified, Roth IRA include:

- Account holder must have earned income (income limits differ from those of a Traditional IRA)
- Account holder must NOT participate in an employer-sponsored retirement plan OR does participate in an employer-sponsored retirement plan and meets certain income requirements (income limits differ from those of a Traditional IRA)
- Distributions are NOT taxed if received on or after the account holder turns age 59 ½ and at least five years after the year in which the account holder made his first contribution to the account
- The required minimum distributions does not apply

**401(k) Plans**

A 401(k) is a defined contribution plan that is a cash or deferred arrangement. It allows the employee to specify the amount of his income to be deducted from his wages for contribution into the plan. The employer is permitted to match some, or all, of these contributions. Contributions are made pre-tax and they accumulate untaxed, along with interest credited, until they are withdrawn. When withdrawn, benefits are taxed as ordinary income and not at the lower capital gains tax rate.

Special rules regulate the operation of a 401(k) plan. For example, a dollar limit is set on the amount an employee may elect to defer each year. Employers are required to inform employees of any applicable limits. In 2009 and 2010, the maximum employee contribution permitted is $16,500 and will be subject to cost of living increases after 2010.

Penalties apply for withdrawals made prior to age 59½ and required minimum distributions must begin no later than April 1st following the year the account holder turns age 70½ OR the year the employee retires—depending upon plan provisions.

**Roth 401(k)**

This plan was introduced in 2006 and permits an employee to irrevocably designate some or all of his or her elective contributions under the 401(k) plan as designated Roth contributions. The plan must contain language that allows for these Roth contributions.

Designated Roth contributions are elective contributions that, unlike pre-tax elective contributions, are currently includible in gross income. If a 401(k) plan is going to provide for designated Roth contributions, it must also offer pre-tax elective contributions. A designated Roth account is a separate account under a 401(k) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses is maintained.
Designated Roth contributions are treated the same as pre-tax elective contributions for most purposes, including:

- The annual individual elective contribution limit (aggregate of all designated Roth contributions and traditional, pre-tax contributions) - $16,500 in 2009 and 2010, with an additional $5,500 in 2009 and 2010 if age 50 or over, and subject to cost-of-living adjustments for future years
- Determining the maximum employee and employer annual contributions - the lesser of $49,000 or 100% of compensation for 2009 and 2010 and subject to cost-of-living adjustments thereafter
- Non-discrimination testing
- Required minimum distributions

**TAX SHELTERED ANNUITY/403(B)**

A 403(b) plan, also known as a Tax Sheltered Annuity (TSA) plan, is a retirement plan for certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers. Individual accounts in a 403(b) plan can be any of the following types:

- An annuity contract,
- A custodial account, which is an account invested in mutual funds, or
- A retirement income account set up for church employees; retirement income accounts can invest in either annuities or mutual funds

Three major benefits exist to TSAs. The first benefit is the income tax deferral of contributions. Allowable contributions to a 403(b) plan are either excluded or deducted from the contract owner’s income. However, if contributions are made to a Roth contribution program, this benefit does not apply. Instead, the contract owner pays income tax on the contributions to the plan but distributions from the plan (if certain requirements are met) are tax free. Employees usually must pay social security and Medicare tax on their contributions to a 403(b) plan, including those made under a salary reduction agreement.

The second benefit is that earnings and gains on TSA plan contributions are not taxed until they are withdrawn. Earnings and gains on amounts in a Roth contribution program are not taxed if withdrawals are allowable distributions. Otherwise, they are taxed when withdrawn.

The third benefit is that TSA plan owners may be eligible to take a credit for elective deferrals contributed to the account.

Only eligible employees may participate in a 403(b) program, and include:

- Employees of a 501(c)(3) organization
- Employees of public school systems who are involved in the day-to-day operations of the school
- Employees of cooperative hospital service organizations
- Civilian faculty and staff of the Uniformed Services University of the Health
Sciences (USUHS)

- Employees of public school systems organized by Indian tribal governments
- Certain ministers
  - Those employed by 501(c)(3) organizations
  - Self-employed ministers
  - Ministers/chaplains who are employed by non-501(c)(3) organizations AND who function as ministers in their day-to-day professional responsibilities with their employers

Only employers can set up 403(b)s. If a self-employed individual wants to take advantage of a TSA or 403(b), the organization with which he is associated must set up the account for his benefit.

Contributions may be made as elective deferrals (a salary reduction agreement), non-elective contributions (employer contributions not part of a salary reduction agreement), or after-tax contributions of the individual (that are not Roth contributions and that are made from income that is included on the federal tax return). A combination of the above types of contributions is permitted.

**Simplified Employee Pension (SEP) Plan**

A Simplified Employee Pension Plan (SEP) is very similar to an IRA and provides employers with a simplified method to contribute toward their employees’ retirement and, if self-employed, their own retirement. Contributions are made by the employee and/or employer into traditional IRAs owned by each employee. Each employee is 100% vested in the contributions. The account must be set up to allow for employer contributions and SEPs are subject to very few reporting and disclosure requirements.

A formal, written agreement must be completed. An individual SEP agreement may be designed by the employer, the IRS model SEP may be adopted by utilizing IRS Form 5305-SEP, or a prototype SEP approved by the IRS may also be used. Each eligible employee must be given certain information about the SEP. The IRS Form 5305-SEP contains the information that must be provided; if the employer did not utilize a 5305-SEP, it still must provide similar disclosure.

Eligible employees include an individual who is at least twenty-one years of age, who has worked for the employer at least three of the past five years, and who has received at least $550 in annual compensation in 2009 and 2010. Employers are permitted to use less restrictive requirements to determine eligibility but may not impose stricter eligibility guidelines. Annual contribution limits cannot exceed the lesser of 25% of the employee’s wages or $49,000 in 2009 and 2010, subject to cost of living adjustments in later years. A 10% penalty applies to withdrawals made before age 59 ½ - with a few exceptions applying. Minimum distribution requirements exist and are the same as those for a traditional IRA.
ANNUITIES AND RETIREMENT PLANNING

If a consumer has a retirement plan funded wholly or in part by his employer, it forms a terrific base for his retirement plan. However, because he has little or no control over the type of plan established, and no guarantee that the plan will remain in place until his retirement date, a consumer is wise to establish his own retirement plan. IRAs and SEPs are excellent retirement vehicles; unfortunately, the amount of money a consumer may contribute is limited. An annuity is the only vehicle a consumer may purchase for funding retirement that does not limit contributions.

Some of the reasons for purchasing an annuity as a retirement vehicle include:
• Investment earnings are tax-deferred until withdrawn
• An annuity is free from the claims of creditors in most states
• If the annuitant/owner dies during the accumulation period, the account value passes to the beneficiaries while avoiding probate
• The contract owner makes the choice about how to receive retirement income
• No income tests are required
• Unless the annuity is qualified, there are no required minimum distributions
• An annuity can help the owner avoid outliving his assets
• An annuity does not impose contribution limits

Some of the reasons not to purchase an annuity as a retirement vehicle include:
• Non-qualified annuity contributions do not benefit from tax-deferral
• Once the contract is annuitized, future changes to the payout method are not permitted
• Surrender charges are imposed on withdrawals within the early years (usually seven, but the range is five to twenty years)
• Purchase of an annuity may incur costs, such as annual fees, investment management fees, insurance and mortality expenses, etc.
• The federal 10% penalty will apply, along with ordinary income taxation (unless the contract owner meets one of the exceptions), if withdrawals are made prior to the owner’s age 59 ½
• Investment gains are taxed as ordinary income and not at the lower rate for capital gains
• Loss of step-up basis at death; estate tax laws allow some investment vehicles to be passed to the beneficiaries and valued on the owner’s date of death—annuities do not have this feature
CHAPTER 6 – REVIEW QUESTIONS

*Answers are in the back of the text*

1. A qualified annuity is purchased with ______.
   [a] A lump sum premium
   [b] Flexible premiums
   [c] Pre-tax dollars
   [d] After-tax dollars

2. In defined contribution plan, investment decisions are usually made by ______.
   [a] The employer
   [b] The employee
   [c] The IRS
   [d] The insurance company

3. A Tax Sheltered Annuity Plan is also known as a ______.
   [a] 401(k) plan
   [b] Roth 401(k) plan
   [c] 403(b) plan
   [d] Defined benefit plan
Chapter 7

Taxation of Qualified and Non-Qualified Annuities

The money paid into an annuity is referred to as a premium; it is the contract owner’s original contribution, also called the principal contribution. Premium dollars accumulate at interest within an annuity, and they compound on a tax-deferred basis until withdrawn, unlike money in a savings account, mutual fund, or certificate of deposit. This means that no taxes are imposed while the premiums and earnings remain inside the contract.

Everything changes when money is withdrawn from the annuity contract and it doesn’t matter if a partial withdrawal is made or if the entire account values are withdrawn. Each withdrawal from an annuity is subject to taxation and the manner of taxation depends upon whether the premiums paid into the annuity were made with pre-tax dollars or after-tax dollars. The rate of taxation is the ordinary income tax rate based on the income tax bracket of the recipient and NOT the lower capital gains tax rate.

PAYMENT OF PREMIUMS

The sum of all premium payments made into a non-qualified annuity with after-tax dollars is considered the cost basis of the contract. Because the money was previously taxed, it will never again be subject to taxes. If premiums paid into an annuity include both after-tax dollars and pre-tax dollars, then the cost basis of the contract will be reduced by the amount of the premiums made with pre-tax dollars.

For example, if a consumer purchased a non-qualified annuity with a $10,000 lump sum of after-tax dollars, the cost basis in the contract is $10,000. If the account value of the annuity is $10,500 one year later (after interest has been credited), the cost basis is still $10,000. The gain, or earnings, in the contract is $500. The $500 gain is subject to taxation at withdrawal but the $10,000 is not.

Another example involves a consumer purchasing an annuity with $5,000 of pre-tax premiums. A year later, he makes a contribution of $5,000 using after-tax dollars. The cost basis in the contract is now $5,000. One year after the second premium payment of $5,000, when the account value is $10,400, the cost basis is still $5,000 and the amount subject to taxation at withdrawal is $5,400.

CASH VALUE ACCRUAL

Cash values accrue within annuities, regardless of their type, on a tax-deferred basis. Taxes are not paid on an annual basis as growth is credited, as is the case with other types of investments such as bonds and certificates of deposit. But taxes will be paid when
funds are withdrawn. California Insurance Code (CIC) stipulates certain requirements with respect to the growth of cash value inside an annuity contract for contracts issued before January 2006. These laws assure consumers that, even if they stop contributing to their annuities, they’ll still receive a cash benefit.

With respect to annuity contracts providing for flexible premium payments, the minimum non-forfeiture amount at any time on or before annuitization will be equal to the accumulation of funds at a rate of interest equal to 3%. That amount may be decreased by the sum of any prior withdrawals or partial surrenders accumulated at a rate of interest equal to 3% and the amount of any indebtedness to the insurance company pertaining to the contract, including interest due and accrued, and increased by any existing additional amounts credited by the company to the contract.

The net premium payments for a given contract year used to define the minimum non-forfeiture amount will be an amount not less than zero and shall be equal to the corresponding gross premiums credited to the contract during that contract year. From that amount, deductions will be made for an annual contract charge of thirty dollars ($30) and a collection charge of one dollar and twenty-five cents ($1.25) per premium payment credited to the contract during that contract year. The percentages of net premiums will be 65% of the net premiums for the first contract year and 87.5% of the net premiums for the second and later contract years. The percentage will be 65% of the portion of the total net premiums for any renewal contract year which exceeds by not more than two times the sum of those portions of the net premiums.

With respect to contracts providing for fixed scheduled premium payments, minimum non-forfeiture amounts will be calculated on the assumption that premiums are paid annually in advance and will be defined as for contracts with flexible premium payments that are paid annually with two exceptions:

1. The portion of the net premiums for the first contract year to be accumulated will be the sum of 65% of the net premiums for the first contract year plus 22.5% percent of the excess of the net premiums for the first contract year over the lesser of the net premiums for the second and third contract years, and
2. The annual contract charge will be the lesser of thirty dollars ($30) or 10% of the gross annual premiums.

With respect to contracts providing for a single premium payment, minimum non-forfeiture amounts will be defined as for contracts with flexible premium payments except that the percentage of net premiums used to determine the minimum non-forfeiture amount will be equal to 90% and the net premiums will be the gross premiums less a contract charge of seventy-five dollars ($75).

**PARTIAL WITHDRAWALS**

A partial withdrawal is defined as the withdrawal of an amount less than the entire cash surrender value of an annuity contract. Many contracts permit annual withdrawals of a certain amount without imposition of a surrender charge; usually this amount is 10% of
the contract value. The Tax Equity and Fiscal Responsibility Act of 1982 changed the taxation on withdrawals from annuities. With annuities purchased before August of 1982, partial withdrawals and surrenders were taxed only after the contract owner had withdrawn an amount equal to his original investment in the contract, called the cost basis. With annuities purchased after August of 1982, taxation works just the opposite: partial withdrawals and surrenders are considered taxable interest payments first; once all interest is withdrawn and taxed, then the owner may have his return of cost basis treated as tax-free.

Depending upon the type of funds in the contract—qualified, non-qualified, or both—taxation will be assessed differently for lump sum withdrawals and those taken over the contract owner’s lifetime, or five years, whichever is longer. When a lump sum withdrawal is made, any money that has not been previously taxed must be withdrawn first. For example, a consumer deposited $100,000 into a non-qualified deferred annuity that earned $20,000 in interest over a period of years. If the contract owner wanted to withdraw $20,000, the entire amount is taxable. This is known as the principal of taxation based on the last money in is the first money taxed, or LIFO (last in, first out). If the contract owner withdrew $25,000, the first $20,000 would be taxed and the last $5,000 would not be taxed, because it would be considered a return of previously taxed principal—or a return of the cost basis.

When a withdrawal is made over the lifetime of the contract owner (or five years, whichever is longer), the withdrawal will be taxed differently. The $20,000 of interest already earned, plus the future interest earnings, will be pro-rated over the annuitization period. If the consumer received $10,000 in payments each year, the actuarial figures might show that $3,000 of the $10,000 represented interest; only the $3,000 would be taxable and the remaining $7,000 would be considered a return of previously taxed principal.

If a contract owner lives long enough, it is possible for all principal to be withdrawn from the annuity and payments after the principal is depleted would be fully taxable.

The IRS imposes a 10% penalty in most cases when a withdrawal is made from an annuity before the contract owner reaches age 59 ½. This type of withdrawal is called an “early” or “premature” withdrawal. Some exceptions to this penalty exist:

- The contract owner receives a distribution from a retirement plan (other than an IRA) after leaving a job and is age 55 or older (age 50 or older for qualified public safety employees),
- The contract owner has un-reimbursed medical expenses that are more than 7.5% of his adjusted gross income,
- The distributions are not more than the cost of the contract owner’s medical insurance (IRA only),
- The contract owner is disabled,
- They are a beneficiary of a deceased plan participant or IRA owner.
- The contract owner has annuitized the contract.
- The distributions are not more than the contract owner’s qualified higher education
expenses (IRA only),
• The contract owner uses the distributions to buy, build, or rebuild a first home (IRA only, and limited to $10,000),
• The distribution is due to an IRS levy,
• The distribution is a qualified reservist distribution,
• The distribution is made to an alternate payee under a QDRO,
• The contract owner is receiving a distribution timely made to reduce excess contributions under a 401(k) plan,
• The contract owner is receiving a distribution timely made to reduce excess employee or matching employer contributions (excess aggregate contributions),
• The contract owner is receiving a distribution timely made to reduce excess elective deferrals, or
• The contract owner is receiving a permissible withdrawal from an Eligible Automatic Enrollment Arrangement (EACA)

LOANS AND ASSIGNMENTS

Any loan, assignment (including collateral assignments), pledge, or agreement to loan, assign, or pledge any portion of a qualified annuity contract’s cash surrender value is treated as a withdrawal from the contract. Therefore, the taxation that normally applies to qualified annuity withdrawals also applies to loans, assignments, or pledges of annuity contract values. In some circumstances, the loan amount may be fully taxed.

Loans against non-qualified annuity contracts generally do not involve a tax consequence.

If an annuity contract owner transfers ownership of a non-qualified annuity issued after April 22, 1987, the owner must pay income tax on the earnings in the contract at the time of the transfer—except for transfers to a spouse or transfers made incidental to a divorce. If the contract was issued before April 22, 1987, the contract’s earnings may continue to be deferred and the old cost basis will be transferred to the new owner. The addition or deletion of a joint owner is considered a transfer of ownership. A transfer of ownership may result in gift tax consequences for the owner.

IRS CODE SECTION 1035 EXCHANGES

<table>
<thead>
<tr>
<th>Internal Revenue Code Section 1035 permits the tax-free exchange of life insurance policies and annuity contracts before annuitization takes place. A 1035 exchange allows the policy or contract owner to exchange out-of-date policies and contracts for more appropriate and current policies and contracts while retaining the cost basis of the original. For a policy or contract to retain the tax-free advantages of the 1035 exchange, certain requirements must be met:</th>
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<tr>
<td>• No gain or loss will be recognized on the exchange</td>
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<tr>
<td>• Constructive receipt of funds cannot be accepted by the contract owner; this means that funds must be exchanged directly between the insurance companies and the owner</td>
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contract owner should not receive any funds, at any time

- The exchange must be “like to like,” as in the annuitant, contract owner, and beneficiaries must be the same on both the old and new contracts

Section 1035 exchanges also allow rollovers or direct transfers from qualified retirement plan contracts, such as an IRA, into a qualified annuity. It is sometimes possible to transfer, tax-free, a portion of an old contract into a new contract while keeping a portion of the old contract from which the partial transfer was taken. Special rules apply to guarantee that either a complete or a partial transfer qualifies for tax-free treatment under Section 1035.

The reasons for an exchange of annuity contracts may include:

- The fixed annuity contract has a significantly lower interest rate than other contracts that currently available.
- The financial stability of the insurance company that issued the annuity current contract has weakened since the contract was issued.
- A new, replacement contract may have much better features, for example, an enhanced death benefit, a guaranteed minimum income benefit, portfolio rebalancing, or dollar cost averaging.
- A new contract may also have more or better-performing investment options available.
- The new contract may also contain lower fees and charges.

Cancelling or surrendering an annuity contract for the purpose of exchanging or replacing it for a new contract is not always in the best interests of the consumer. Most producers handle the replacement of annuity contracts in a legal and ethical manner. In order to protect consumers from the occasional dishonest practitioner, California has (as have most other states) enacted legislation concerning the replacement of life insurance and annuity products.

When a producer completes an application for the sale of an annuity, he must sign a statement that becomes part of the application indicating whether replacement is—or may be--involved in the transaction. If replacement is, or may be, involved, the producer must supply the insurance company with the following information:

- A list of all policies to be replaced, including policy numbers, insurance company names, and insured persons
- A copy of the replacement notice required by CIC

Within three business days of the proposed insurance company’s receipt of the signed annuity application, or the date the annuity contract is issued—whichever occurs first, the insurance company must then send written communication to the insurance companies of the existing policies; the written communication must contain the following:

- A notice that replacement of the policy or policies is anticipated
- Identification information concerning the existing policy/policies to be replaced
- A policy summary, ledger summary, or ledger statement containing policy data on the proposed annuity contract
The insurance companies of the existing policies must send to the policy owner, within twenty days of their receipt of the written communication concerning replacement, policy summaries or ledger statements containing policy data about the existing policies. Information relevant to premiums, cash values, death benefits, and dividends on the existing policy must be calculated from the current policy year. The policy summaries and ledger statements must also include the amounts of any outstanding loans or indebtedness, dividend accumulations or dividends, and any other information that does not violate statute.

When the replacement policy is issued, the insurance company must provide written notice, either in the policy or on a separate document, stating that the applicant has the right to an unconditional refund of all premiums paid; this right begins on the date of policy delivery and must be exercised within thirty (30) days.

**GIFT OF AN ANNUITY**

A number of reasons exist for an individual to make a gift of an annuity. Each annuity gift situation will entail certain taxable consequences, and contract provisions, and a producer should discuss all consequences and provisions with the contract owner.

For example, a grandparent may want to fund education costs for a grandchild. The Uniform Gifts to Minors Act (UGMA) allows the annuity to be held in the child’s name, using the child’s social security number for taxation purposes. When the time for withdrawals occurs, the child pays the 10% premature withdrawal penalty, along with taxes on the earnings.

Another example involves a charitable gift annuity. A charitable gift annuity is a contract under which a charity, in return for a transfer of cash, marketable securities, or other assets (i.e. property, real estate) agrees to pay fixed annuity payments to one or two life annuitants, for their lifetimes. The annuity is backed by the organization's total assets. Organizations wanting to issue charitable gift annuities must obtain a Certificate of Authority from the California Division of Insurance. It should be noted that charitable gift annuities are not protected by the California Life and Health Insurance Guarantee Fund.

If a contract owner gives an annuity contract as a gift, the contract owner may have to pay income tax at the time of the transfer. The contract owner must include in the amount of income reported to the IRS the difference between the cash surrender value of the contract and the owner’s investment in the contract at the time of the transfer. This rule does not apply if the transfer is made between spouses or former spouses as part of a divorce. Gift taxes also may also apply.
SALE OF ANNUITY BY ITS OWNER

Until recently, an annuity contract owner was unable to sell his annuity contract if he decided he didn’t want it anymore. The emergence of a secondary market for such purchases now makes it possible for a contract owner to sell his annuity rather than surrender it or to sell a portion of the annuity payout.

The firms that buy annuities should not charge any fees for their evaluation of the consumer’s contract and should also be willing to work with the consumer AND the consumer’s insurance agent. No conditions or obligations should be connected with the firm’s evaluation of the annuity contract.

Before an annuity owner sells his contract to a firm in the secondary market, he should consider a number of factors. Making the annuity purchase involved much consideration; selling the annuity should involve just as much reflection.

The first factors to consider involve the original purpose of the annuity purchase. Does the consumer still have a future need for a steady, guaranteed income? Does the consumer have other retirement and/or investment vehicles that offer a higher return than the annuity? If the answer to either of the preceding questions is yes, then selling may not be the consumer’s best choice.

The second factor to consider involves the surrender fees and charges in the contract. Will the consumer incur a surrender fee? Does the contract include any provisions that require him to hold the contract for a certain number of years in order to receive interest or benefits under the contract? If the answer to either of the preceding questions is yes, then selling is probably NOT the consumer’s best choice. Imposition of fees and charges will result in a reduction of the annuity contract’s values.

The third factor to consider is the period, or phase, of the annuity. If the contract has already been annuitized, it is unlikely the contract can be sold. Once distributions have begun, it is doubtful the contract owner has the ability to make changes to the payout schedule or amount.

The fourth factor to consider is the tax consequences of selling an annuity. Whenever untaxed earnings or principal are withdrawn from an annuity, tax consequences WILL occur. As with surrender charges and fees, these taxes reduce the amount of money received by the contract owner when an annuity is sold.

DEATH OF AN ANNUITY CONTRACT OWNER

When an annuity owner dies, a number of issues are addressed. First, does the contract include a co-owner or will assets be passed to the owner’s spouse? Does the contract name one or more beneficiaries? These questions are important because tax consequences will apply at the death of the contract owner.
The annuity’s value at the time of the owner’s death will be considered an asset and, as such, will be considered part of the annuity owner’s estate and subject to estate taxes. An exception to estate taxation on annuity assets would apply to annuity assets passing to a surviving spouse, a charitable organization, or a transfer incidental to a divorce.

If a beneficiary receives the annuity’s assets, or if heirs receive them because no beneficiary was named, the beneficiary or heirs will be taxed in the same fashion the contract owner would have been taxed had he received the annuity values. If a beneficiary is named, however, probate will be avoided.

When the contract owner dies before the annuitization period begins, the surviving owner or beneficiary must choose one of the following types of distributions:

- Complete withdrawal of the annuity values within five (5) years, or
- Annuity over the lifetime of the new owner to start within one year of the death of the deceased contract owner.

  - If a spouse is the sole surviving owner, or beneficiary, the spouse can choose to continue the contract
  - If the annuity contract owner is a grantor trust, the death of the grantor requires mandatory distribution

- Mandatory distribution applies to all annuity contracts issued after January 18, 1985

Regardless of other concerns, the following also apply to distributions made when the contract owner dies:

- The 10% premature withdrawal penalty does not apply if the contract owner dies before reaching the age of 59 ½
- The tax rate charged is that of ordinary income, NOT the lower capital gains tax rate, regardless of who receives the distributions
- Refer to the section above on Cash Value Accrual—these CA state regulations concerning how earnings accumulate in an annuity will directly affect taxation when the contract owner dies
- If the owner dies after the annuitization period has begun, the recipient must continue receiving distributions at least as frequently as the owner received distributions.

DEATH OF AN ANNUITANT

When an annuitant dies, a number of issues are addressed. First, was the annuitant also the contract owner? If so, all the details included in the previous section apply. If not, who ARE the owner, co-owner, and beneficiary? These questions are important because tax consequences will apply at the death of the annuitant.

The annuity’s value at the time of the annuitant’s death will be considered an asset of the contract owner and, as such, will be considered part of the annuity owner’s estate and subject to estate taxes. An exception to estate taxation on annuity assets would apply to annuity assets passing to a surviving spouse, a charitable organization, or incidental to a divorce.
If a beneficiary receives the annuity’s assets, or if heirs receive them because no beneficiary was named, the beneficiary or heirs will be taxed in the same fashion the contract owner would have been taxed had he received the annuity values. If a beneficiary is named, however, probate will be avoided.

When the annuitant dies before the annuitization period begins, the surviving owner or beneficiary must choose one of the following types of distributions:

- An immediate lump sum,
- Complete withdrawal of the annuity values within five (5) years, or
- Annuitzation over the lifetime of the new owner to start within one year of the death of the deceased contract owner.
  - If a spouse is the sole surviving owner, or beneficiary, the spouse can choose to continue the contract
  - If the annuity contract owner is a grantor trust, the death of the grantor requires mandatory distribution
- Mandatory distribution applies to all annuity contracts issued after January 18, 1985

Regardless of other concerns, the following also apply to distributions made when the annuitant dies:

- The tax rate charged is that of ordinary income, NOT the lower capital gains tax rate, regardless of who receives the distributions
- If the annuitant dies after the annuitization period has begun, the recipient must continue receiving distributions at least as frequently as the owner received distributions.

### ANNUITY BENEFITS DISTRIBUTIONS

When an annuitant or contract owner dies, annuity benefits are distributed. An annuity contract owner may also make the decision to receive distributions from his annuity at any time, although most contract owners elect to receive distributions at retirement.

Regardless of the reason for opting to receive distributions, certain issues come into play at the time distributions are made:

- Do surrender charges apply? If so, they will be deducted from the account value before distributions are made.
- What payout method is being chosen by the contract owner or beneficiary?
- What will the tax consequences be, specifically:
  - Does the 10% federal penalty apply?
  - Is the annuity a qualified or non-qualified contract?

Taxation is a major issue and few consumers understand how taxes are computed on annuity payouts or how they’ll affect the recipient of the annuity distributions. As we mentioned previously, any premiums that were paid into the annuity with after-tax dollars are not taxed when distributions were made. Premiums paid with pre-tax dollars,
however, and all earnings, are taxed as ordinary income at distribution.

**EXCLUSION RATIO**

When calculating which portion of an annuity distribution payment is taxable, a formula called an exclusion ratio is used. This formula determines which portion of the annuity payment is considered a tax-free return of principal and which portion will be taxed. According to the IRS, the exclusion ratio formula is quite simple:

<table>
<thead>
<tr>
<th>Investment in the Contract</th>
<th>Expected Return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The exclusion ratio is stated as a percentage (rounded to three decimal places) and is applied to each annuity payment received in a taxable year. Application of the exclusion ratio to payments received indicates what portion of the payment is excluded from the recipient’s adjust gross income for the taxable year.

For example, if a contract owner invested $10,000 in a non-qualified annuity and it earned $2,000, his return would be $12,000. The exclusion ratio is $10,000 divided by $12,000, or 83% (.830). If the contract owner receives a monthly annuity payment of $1,000, 83% of that payment ($830 or .830) may be excluded from taxation because it is a tax-free return of principal. The other 17% ($170 or .170), however, is subject to taxation as ordinary income.

As each payment is made, the contract owner’s principal diminishes. Once the contract owner has received the entire value of his principal in untaxed payments ($10,000, using the above example), the total of all future payments will be fully taxable as ordinary income.

**TAX-DEFERRED COMPOUNDING**

When a consumer invests money in a savings account or other vehicle that requires the consumer to pay taxes on the account’s growth each year, a portion of his earnings are reduced by the taxes he pays. When the same consumer invests money in a tax-deferred investment vehicle such as an annuity or IRA, he doesn’t pay taxes on the interest earned in the account until the money is withdrawn, therefore, he has MORE money earning interest in the account and will have MORE money in the future. Not only is his principal earning interest, but his tax-deferred growth is also earning interest. This is known as tax-deferred compounding.

The longer the consumer waits to withdraw from the account, the MORE money he’ll have in it. Another thing to keep in mind is that the higher the rate of return credited to the account, the more tax-deferred compounding works to a consumer’s benefit.
Please note the following chart, which chronicles payments made into a qualified annuity and a savings account:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Contributions</th>
<th>Annuity Value</th>
<th>Savings Account Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>2</td>
<td>$6,000</td>
<td>$6,180</td>
<td>$6,126</td>
</tr>
<tr>
<td>3</td>
<td>$9,000</td>
<td>$9,551</td>
<td>$9,387</td>
</tr>
<tr>
<td>4</td>
<td>$12,000</td>
<td>$13,124</td>
<td>$12,792</td>
</tr>
<tr>
<td>5</td>
<td>$15,000</td>
<td>$16,911</td>
<td>$16,345</td>
</tr>
<tr>
<td>10</td>
<td>$30,000</td>
<td>$39,542</td>
<td>$36,547</td>
</tr>
<tr>
<td>20</td>
<td>$60,000</td>
<td>$110,357</td>
<td>$92,344</td>
</tr>
<tr>
<td>30</td>
<td>$90,000</td>
<td>$237,175</td>
<td>$177,514</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxes Due</th>
<th>Net After Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>- $41,209</td>
<td>$195,966</td>
</tr>
<tr>
<td>none</td>
<td>$177,514</td>
</tr>
</tbody>
</table>

The above figures are based on annual interest earnings of 6% in each account and a tax rate of 30% in year one, 29% in year two, and 28% for the remaining years.

The reason tax-deferred compounding works so well is because instead of reducing the amount of money earning interest by paying taxes, the amount that would otherwise be taxed—and deducted from the account, works for the consumer by earning interest. Even if a consumer makes a single lump sum payment instead of payments over a number of years, tax-deferred compounding will still work to his benefit.

This chart assumes the following conditions:

- Lump sum payment - $10,000
- Interest rate credited – 5%
- Tax rate – 28%

<table>
<thead>
<tr>
<th>Year</th>
<th>Value with Tax-Deferred Compounding</th>
<th>Value with Compounding After Taxes Deducted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,513</td>
<td>$10,369</td>
</tr>
<tr>
<td>2</td>
<td>$11,052</td>
<td>$10,752</td>
</tr>
<tr>
<td>3</td>
<td>$11,618</td>
<td>$11,149</td>
</tr>
<tr>
<td>4</td>
<td>$12,214</td>
<td>$11,560</td>
</tr>
<tr>
<td>5</td>
<td>$12,840</td>
<td>$11,987</td>
</tr>
<tr>
<td>10</td>
<td>$16,487</td>
<td>$14,369</td>
</tr>
<tr>
<td>20</td>
<td>$27,183</td>
<td>$20,647</td>
</tr>
<tr>
<td>30</td>
<td>$44,817</td>
<td>$29,669</td>
</tr>
<tr>
<td>X .72</td>
<td>$32,268</td>
<td></td>
</tr>
</tbody>
</table>

Any investment vehicle that taxes earnings as they’re earned, and not on a tax-deferred basis, will ultimately generate fewer dollars for the consumer’s use at a future point in time. As shown by each of the two preceding charts, the consumer will have just over 10% more money thirty years down the road if he takes advantage of tax-deferred
compounding.

**TAX EFFECT ON BENEFICIARY ESTATE ISSUES**

Naming a beneficiary, or more than one beneficiary, has numerous benefits from a tax perspective. The first benefit is that transfers of assets through beneficiary designations in retirement plans, life insurance, deferred compensation plans, and annuities usually bypass probate and avoid probate-related costs, which reduce the total assets transferred. When a beneficiary has not been named, assets that are typically permitted to bypass probate roll into the contract owner’s estate and will then be subject to probate and probate-related costs. The second benefit of naming a beneficiary is that transferring assets via a beneficiary often results in the deferral of income taxes, thus allowing the assets to continue their tax-deferred growth.

When a spouse is named as beneficiary, for example, assets typically pass to the spouse without being taxed for estate purpose, so long as the total assets of the deceased spouse fall below the exemption amount (i.e. $3,500,000 in 2009). However, when the spouse dies, the assets passing along to the spouse’s beneficiaries/heirs will likely be subject to estate taxation. If the spouse and/or his/her beneficiary/heirs receive the assets of the transfer over a lifetime, as in annuity distributions, the tax-consequences will, at the very least, be spread out over time and may actually result in fewer taxes paid, depending upon the income tax bracket of the recipient when receiving distributions.

**DISCLAIMER – REFER TO ATTACHMENT II**

Attachment II, which appear at the end of this material, describes in detail the following requirements of Section 789 of California Insurance Code:

1. If a producer offers to sell a client any life insurance or annuity product, the producer must advise the client, or the client’s insurance agent, that the sale or liquidation of the produce may have tax consequences.
2. The producer must disclose that the client may wish to consult independent legal counsel or financial advice before buying, selling, or liquidating any assets (including other insurance or annuity contracts) being solicited or offered for sale.
3. The material contained in this course is not intended to provide tax advice concerning issues surrounding income and estate taxation of annuities. If expert tax assistance or advice is required, insurance producers must advise clients to consult with other professionals.
CHAPTER 7 – REVIEW QUESTIONS

Answers are in the back of the text

1. All of the following are terms referring to the monies paid into an annuity EXCEPT _____.
   [a] Premium
   [b] Principal
   [c] Interest
   [d] Original contribution

2. Section 1035 exchanges require that _____.
   [a] A gain is recognized on the exchange
   [b] A loss is recognized on the exchange
   [c] The exchange cannot be “like to like”
   [d] Constructive receipt of funds cannot be accepted by the contract owner

3. The Uniform Gifts to Minors Act (UGMA) allows which of the following _____.
   [a] The gifted annuity is held in the child’s name
   [b] Use of the donor’s social security number for tax purposes
   [c] The child does not have to pay the 10% premature withdrawal penalty
   [d] The child does not have to pay taxes on the annuity’s earnings

4. The exclusion ratio formula is used _____.
   [a] When calculating which portion of annuity distributions are taxable
   [b] When calculating the expected return
   [c] When calculating the investment in the contract
   [d] When calculating the tax-free return of principal
Chapter 8

Advantages and Disadvantages of Annuities

As previously mentioned, annuity contracts are complex and may not meet the needs of every individual. A producer should only recommend the sale of an annuity after considering a consumer’s financial situation, age, other existing investments, and a host of other factors. No two people are the same and the needs of each individual should be met by the annuity contract—or it shouldn’t be sold and purchased.

ADVANTAGES

There are many advantages to purchasing an annuity. Depending upon a particular individual’s financial situation, age, retirement goals, and a variety of other factors, what appears to be an advantageous purchase may turn out to be just the opposite. Listed here are the generic advantages of annuity contracts:

- Tax-deferred growth of principal
- Tax-deferred compounding of interest
- Guaranteed minimum rate of return (fixed annuities)
- Guaranteed lifetime income
- No contribution maximums
- Optional riders and enhanced benefit features
- Multiple investment options (variable annuities)
- Avoid probate court and probate-related costs
- Excellent supplement to employer pension plans, 401(k)s, and IRAs
- Guaranteed death benefit option, and other options
- Appropriate for the long-term investor

DISADVANTAGES

Annuity contracts also contain disadvantages. Depending upon a particular individual’s financial situation, age, retirement goals, and a variety of other factors, what appears to be a disadvantageous purchase may turn out to be so awful. Listed here are the generic advantages of annuity contracts:

- Surrender charges
- Distributions are taxed as ordinary income and not at the lower capital gains rate
- Many guarantees must be purchased
- Many benefits and features incur a charge
- Administrative, mortality, and other fees apply, depending upon the type of annuity
- Partial withdrawals in excess of 10% are usually not allowed without penalty
• Once the contract is annuitized, the owner no longer has access to the principal
• Not for the short-term investor
• 10% federal penalties for withdrawals made prior to age 59 ½
• No step-up basis at death
• Limited number of investment options

ADVANTAGES AND DISADVANTAGES BASED ON AGE

Concern about the inappropriate and unsuitable sales of annuities, especially to seniors, is of major importance to consumers, the State of California, the insurance industry, FINRA, the SEC, insurance companies, and producers. When considering making a recommendation that a consumer purchase an annuity, a producer cannot overemphasize the importance of a suitability evaluation. In particular, the age of the consumer will play an important role in the appropriateness of an annuity contract as a retirement and/or investment vehicle.

For purposes of illustration, we will discuss the various advantages and disadvantages of an annuity purchase based on age. Donald will represent consumers ages 60 and older and Timothy will represent consumers who have not yet turned sixty.

Let’s look at how some of the advantages and disadvantages listed above will affect Donald and Timothy given the following circumstances:

• An inheritance of $100,000 is received
• No retirement plan is in place
• No significant amount of savings exists, nor does any other type of investment vehicle
• Each individual is married, with no children

Why are Donald and Timothy considering the purchase of an annuity? To save for retirement, to guarantee retirement income, or both?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>He’s already retired (or will be very soon), so he doesn’t have time to save. He would like to have a guaranteed income, since he has no retirement plan in place.</td>
<td>He has 5+ years until retirement, so he has some time to save. He would also like to have a guaranteed retirement income since he has no retirement plan in place.</td>
</tr>
<tr>
<td>He needs to determine his income needs for the future and to realistically project them based on his desired lifestyle.</td>
<td>He needs to evaluate his current financial status and realistically project his future income needs and retirement lifestyle.</td>
</tr>
<tr>
<td>The advantages listed above all appear attractive—except for the long-term investor one.</td>
<td>The advantages listed above all appear attractive.</td>
</tr>
<tr>
<td>An immediate fixed annuity may be a suitable purchase; other factors need to be considered.</td>
<td>A deferred fixed, indexed, or variable annuity may be a suitable purchase; other factors need to be considered.</td>
</tr>
</tbody>
</table>
When will Donald and Timothy need to withdraw the money invested in the annuity?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>He can use some income now—or very soon.</td>
<td>He won't need to withdraw the money until he retires—or loses his job or his health or experiences some other emergency.</td>
</tr>
<tr>
<td>An immediate fixed annuity is still in the picture. Let’s do some more evaluation.</td>
<td>If he needs to withdraw more than 10% of the contract values prior to age 59 ½, the federal 10% penalty will apply, as will taxation at ordinary income rates and the contract’s surrender charges.</td>
</tr>
</tbody>
</table>

What percentage of the $100,000 is appropriate to invest in an annuity?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Since he doesn’t have significant savings, investments, or other retirement funds, investing his entire $100,000 is NOT a good idea. He needs to consult with a financial planner to determine the appropriate percentage of his $100,000—if any—to invest in an annuity.</td>
<td>Since he doesn’t have significant savings, investments, or other retirement funds, investing his entire $100,000 is NOT a good idea. In addition, if he makes a withdrawal from the annuity prior to age 59 ½, he’ll incur the federal 10% penalty PLUS the contract penalties for premature withdrawals. He needs to consult with a financial planner to determine the appropriate percentage of his $100,000—if any—to invest in an annuity.</td>
</tr>
</tbody>
</table>

What guarantees are offered in various types of annuity contracts?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable annuities contain fewer guarantees and more risk than fixed or indexed annuities, so a variable contract is not a suitable choice—especially in view of the fact that he doesn’t have any other savings, investments, or retirement funds. In addition, the fees and charges related to a variable annuity will take a large chunk out of his investment, especially since he doesn’t have a long period of time in which to invest.</td>
<td>Although variable annuities contain fewer guarantees and more risk than fixed or indexed annuities, investing some of his money in a variable annuity will allow him the opportunity to realize a greater gain than if he purchased a fixed or indexed annuity. On the other hand, he doesn’t have a lot of money to invest—or risk. He also has that 10% penalty and surrender charges to worry about if he needs money before turning age 59 ½.</td>
</tr>
<tr>
<td>Fixed annuities contain more guarantees than variable annuities, and he especially likes that if he dies, his wife will receive annuity benefits as his beneficiary. He also likes his guaranteed lifetime income and the fact that his wife can receive benefits from the annuity if he dies before she does. He also likes his</td>
<td></td>
</tr>
</tbody>
</table>
that a fixed annuity will guarantee him monthly income for life.

options in an indexed annuity.

What fees are associated with various types of annuity contracts?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable annuities involve a lot of fees: mortality and insurance expenses,</td>
<td>Variable annuities involve a lot of fees: mortality and insurance expenses,</td>
</tr>
<tr>
<td>administrative charges, and surrender charges. In addition to the risk factor,</td>
<td>administrative charges, and surrender charges. In addition to the risk factor,</td>
</tr>
<tr>
<td>the reduction of his contract value due to fees is not beneficial. Depending</td>
<td>the reduction of his contract value due to fees is not beneficial. Then again,</td>
</tr>
<tr>
<td>upon his actual age, he may not live long enough to recoup the expense.</td>
<td>he may have a number of years to grow his investment.</td>
</tr>
<tr>
<td>Although a fixed annuity doesn't involve a lot of inherent fees, the charges</td>
<td>Although a fixed annuity doesn't involve a lot of inherent fees, the charges</td>
</tr>
<tr>
<td>associated with extra benefits will deplete his contract values. He's not</td>
<td>associated with the extra benefits he finds beneficial may be recouped if he</td>
</tr>
<tr>
<td>sure exactly what benefits he needs.</td>
<td>keeps the annuity long enough.</td>
</tr>
</tbody>
</table>

What is the risk tolerance of each individual?

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Because of his age, the fact that he is already retired, or near retirement,</td>
<td>The longer period of time between his investment in an annuity and his</td>
</tr>
<tr>
<td>and doesn't have a lot of liquidity, his risk tolerance is conservative.</td>
<td>retirement age, the greater his risk tolerance will be. Of course, because</td>
</tr>
<tr>
<td>Donald doesn't have time or money to play with.</td>
<td>he doesn't have a lot of liquidity and doesn't have another retirement</td>
</tr>
<tr>
<td></td>
<td>vehicle, his risk tolerance may be quite conservative.</td>
</tr>
</tbody>
</table>

A few other things to keep in mind:

<table>
<thead>
<tr>
<th>Donald (60+)</th>
<th>Timothy (&lt;60)</th>
</tr>
</thead>
<tbody>
<tr>
<td>If he purchases an immediate annuity, he will no longer have access to the</td>
<td>Even if he purchases a variable annuity, his investment options are limited.</td>
</tr>
<tr>
<td>assets he invested, although he will have a guaranteed retirement income</td>
<td></td>
</tr>
<tr>
<td>for life and may also provide benefits to his wife when he dies.</td>
<td></td>
</tr>
<tr>
<td>If he purchases a variable annuity, it is very likely that he’ll incur</td>
<td>When he receives distributions, they will be taxed as ordinary income, not</td>
</tr>
<tr>
<td>surrender charges because a variable annuity usually contains a longer</td>
<td>as capital gains—as they might be taxed in other investments.</td>
</tr>
<tr>
<td>surrender charge period than a fixed annuity. He’ll also sacrifice some of his</td>
<td></td>
</tr>
<tr>
<td>earnings to fees.</td>
<td></td>
</tr>
</tbody>
</table>
COMPARISON WITH OTHER INVESTMENT VEHICLES

Consumers have opportunities to invest their money, especially their retirement funds, in a vast array of vehicles other than annuities. That list includes:

- Annuities – Fixed, Indexed, and Variable
- Certificates of Deposit
- Money Market Accounts
- Savings Accounts
- Mutual Funds
- Stocks
- Bonds
- Commodities
- Options
- Limited Partnerships
- Promissory Notes
- Real Estate Investment Trusts
- Viatical Settlements

Annuities are geared toward the long-term investor and not every consumer has long-term goals or needs in mind. It is important for a producer to understand what other alternatives exist for the consumer. Being aware of these alternatives indicates the knowledge base of the producer and also assists in the suitability evaluation.

ALTERNATIVES TO FIXED ANNUITIES

Although traditional fixed annuities do not offer a high rate of investment growth, their primary advantages involve tax-deferred growth and their safety and security. Other investment products that are considered safe are bank savings accounts, certificates of deposit, government issued securities, and money market accounts.

Bank Savings Accounts

A bank savings account is designed to hold money to which a consumer doesn’t need immediate access. In exchange for allowing the bank to hold his money, a consumer earns interest on the money in the savings account. Because access to the funds in a savings account is slightly more restrictive than access to funds in a bank checking account, the bank usually pays a slightly higher rate of interest on money in savings accounts. Still, the rate of interest paid on savings accounts is considerably less than the rate of interest paid on assets in a fixed annuity.

Money deposited in a savings account is considered liquid; all a consumer has to do is visit the bank and made a withdrawal to have full access to his funds. In this respect, a bank savings account has a huge advantage over a fixed annuity. On the other hand, a fixed annuity earns much more interest—and on a tax-deferred basis. A consumer pays taxes each year on the bank interest he earns, as interest income, which reduces his gain on the account and has a negative effect on compounding.
Money in a bank savings account is considered safe. Bank depositors are insured for up to $100,000 through the Federal Deposit Insurance Corporation (FDIC); if a bank fails, assets in the account are protected up to this amount. Annuity contracts are also considered safe if they are issued by a financially sound insurance company. Annuity contracts issued by admitted insurance carriers in the State of California are protected by the California Life and Health Insurance Guarantee Association for up to 80% of the annuity’s present value (including net cash surrender values and net cash withdrawal values), to a maximum of $100,000 per contract owner—regardless of the number of annuity accounts owned.

As with all investments, the lower the risk, the lower the return. Bank savings accounts are considered very low risk.

**Certificates of Deposit (CD)**

Certificates of deposit earn interest in a fashion similar to bank savings accounts, but at a higher rate. The reason the bank offers a higher rate of interest is because it expects the consumer to keep his money in the CD for a specific period time; the longer the term of the CD, the more interest the consumer earns. For example, a two-year CD will receive a higher interest rate than a six-month CD.

Banks and credit unions typically issue certificates of deposit, but brokerage firms also issue CDs. Oftentimes, a brokerage CD will offer a higher rate of interest than a bank or credit union because in competes in a national marketplace rather than a regional or local marketplace. It can also have other terms, restrictions, and conditions.

When the CD term ends, the bank will usually renew the CD automatically unless the consumer provides other instructions. The window for providing instructions to the bank is usually 1-2 weeks. If money is withdrawn from a CD before its maturity date (the end of the CD term), penalties apply and can be quite significant, resulting in not only loss of interest but also in loss of principal. Federal guidelines stipulate minimum penalties; a bank or other financial institution is permitted to charge higher fees IF those higher fees are disclosed when the CD account is opened.

CDs are more liquid than fixed annuities but the interest earned on a CD is taxable each year as interest income; the taxes reduce the overall annual gain on the account. CDs issued by banks and credit unions are considered as safe as funds in a bank account; CD deposits are protected by the FDIC.

As with all investments, the lower the risk, the lower the return. Traditional certificates of deposits are considered low risk.

**Government Issued Securities**

Investing in securities issued by the federal government is considered very safe and a consumer may invest with as little as $25. Examples of government issued securities include:

- Treasury Bills – can be purchased at a discount (which is determined at auction) and
mature in less than 1 year; can be sold at any time at current market value; minimum purchase is $100

• Treasury Notes – are purchased with maturity dates of 2, 3, 5, 7, and 10 years; earn interest every six months; interest rate is determined at auction; can be sold any time at current market value; minimum purchase is $100

• Treasury Bonds – are purchased with maturity dates of 5, 10, and 20 years; earn interest every six months; interest rate is determined at auction; can be sold any time at current market value; minimum purchase is $100; principal is adjusted with inflation as measured by the Consumer Price Index (CPI)

• Series EE/E Savings Bonds—minimum purchase $25 (if made online, otherwise, $50); maximum purchase per year $5,000; pay a fixed rate of interest, based on current market rates at issue; interest is credited through an increase in a bond’s value each month and is paid when the bond is redeemed or cashed in; bonds can be redeemed or cashed-in after one year but 3 months of interest is forfeited if a bond is redeemed within five years of purchase; issued for a term of 30 years

• Series I Savings Bonds—minimum purchase $25 (if made online, otherwise, $50); maximum purchase per year $5,000; inflation adjusted interest accrues monthly and is paid when the bond is redeemed or cashed in; bonds can be redeemed or cashed-in after one year but 3 months of interest is forfeited if a bond is redeemed within five years of purchase; issued for a term of 30 years

Interest earned on government issued securities is exempt from state and local income taxes but is subject to federal income taxes in the year earned. The interest rate does not change during the five-year period of a bond, so these types of investments do not keep up with inflation.

Because these investments are virtually risk-free (they’re backed by the U.S. government), the investment return is not very high. Depending upon the type of government issued security purchased, a consumer has some degree of liquidity. If penalties are imposed for premature redemption, they are not usually as significant as those imposed by fixed annuities.

As with all investments, the lower the risk, the lower the return. Government issued securities are considered to involve the lowest of all risks when investing.

Money Market Accounts
While a money market account is not considered as safe as a bank savings account, certificate of deposit, or government issued securities, it is considered a secure cash management tool. The definition of money market account is: *A savings account that offers the competitive rate of interest (real rate) in exchange for larger-than-normal deposits.*

A money market account works like a bank savings account, except that large sums of money are expected to be deposited. A consumer deposits his money in a money market fund which, in turn, invests the money by issuing short-term loans. The investments average about ninety days, with thirteen months being the maximum length; the rationale
behind the short-term investing is to reduce risk. Some types of investments in money market funds include U.S. Treasury issued securities, short-term corporate paper, and certificates of deposit. The fund pays a portion of its investment return to the consumer as a dividend, usually monthly.

Money market funds are considered securities, so they do involve some risk, which is a disadvantage. In exchange for this risk, interest rates on money market accounts are higher than those credited to the investments previously discussed. Other disadvantages include the lack of interest rate guarantees and the effect of inflation if investing in money market accounts for the long-term.

The biggest advantage of a money market account is its liquidity; cash is usually available within a few days. Some money market accounts actually issue checkbooks to facilitate the consumer’s access to his cash.

Money market accounts are considered to be fairly low risk investments.

**ALTERNATIVES TO VARIABLE ANNUITIES**

Although variable annuities involve risk and few guarantees, they can be an appropriate purchase if a consumer has other investment vehicles in place, such as low-cost, tax-efficient mutual funds and a 401(k) or IRA into which the consumer has deposited his maximum contributions. Other considerations for the advantageous purchase of a variable annuity include careful evaluation of the cost benefits of tax-deferral against a lack of liquidity, the higher expenses and fees inherent in variable contracts, and a certainty that funds in the variable annuity will not be needed before the contract owner turns age 59 ½.

Other investments to be considered as an alternative to a variable annuity are [a portfolio of] index mutual funds and tax-managed funds. **Index mutual funds** often offer the same return as a variable annuity but contain lower expenses and may provide more advantageous tax treatment (capital gains versus ordinary income). If a portfolio of index funds is purchased, it is a way to own a portion of most publicly traded stock that is available, which significantly reduces investment risk because of the collective investment of all stocks: if one stock performs poorly, another is undoubtedly performing well. Two caveats: (1) if fund shares are sold at a profit, the profit will be taxed in that year as a capital gain, even if the overall portfolio does not realize a profit, and (2) tax managed funds are not appropriate for retirement accounts.

**OTHER INVESTMENT OPTION ALTERNATIVES TO ANNUITIES**

**Retirement Income Fund**

A retirement income fund is a securities product designed for investors already in retirement. It is a fund of funds structure that holds a diverse portfolio of stock and bond funds; neither principal nor returns are guaranteed. Some of these funds perform well over time and offer the potential for a high return; because of this potential this type of investment retains a higher element of risk than other investment vehicles we discussed.
**Laddered Bonds**

Because bonds are low-risk, an effective way of providing for retirement would be to purchase bonds with different maturity dates, staggering them over a period of time so that one bond matures each year. For example, if a consumer built a bond ladder, each bond could meet his cash needs in the particular year when it was redeemed. This plan may not provide as much income as an immediate annuity would, but it allows the consumer ownership of, and access to his principal—something an annuity does not allow once it’s been annuitized. A CD ladder is another way of accomplishing this same goal. Alternately, a consumer could build a ladder incorporating bonds, CDs, and a fixed annuity to benefit from all possible tax advantages and contract guarantees.

**Stocks**

Investing in stocks is a way for an investor to own portions of businesses. A share of stock equals a proportional share of ownership in a business. As the business’ value increases or decreases, so do the value of the shares of stock owned by the investor.

Historically, stocks have experienced better returns than bonds and other investments. Although the returns are often greater than those inherent to other types of investment vehicles, so are the risks. If the business fails, the individual who invested in the business by purchasing stock may not realize a profit and may, in fact, lose his original investment.

**Commodities**

 Basically anything that is tied to, or comes out of, the ground is classified as a commodity, i.e. gold, silver, livestock, crops, oil—anything related to food, energy, or metals. Investing in commodities is very risky and is recommended only for the experienced investor—and someone with lots of money to fall back on. Of course, the higher the risk, the higher the reward; some commodities investors realize excellent returns on their investments.

One of the popular ways to invest in commodities is through a futures contract, in which the investor guarantees to buy or sell in the future a specific quantity of a commodity at a specific price. Most investors in the futures market are commercial users of the commodities they trade or are speculators who hope to profit from changes in the price of the futures contract.

Some advantages include the potential for large profits if the consumer comes out “on the right side of the trade,” the availability of minimum-deposit accounts, and the ease with which a consumer can expect a rise or fall in value. Some disadvantages include a very volatile and risky market and leverage, which amplifies gains and losses.

**Options**

An option is a contract that gives the buyer the right to buy or sell an asset at a specific price on or before a specific date; the has no obligation to buy. An option is a securities product and can only be sold by an individual holding a securities license. It is also a legal contract that contains terms and properties that are strictly defined.
In order to satisfactorily invest in options, an investor must correctly determine the direction of a particular stock’s movement—whether its value will increase or decrease AND how much it will increase/decrease within a specific time period.

Investing in options is considered very risky and the only funds that are recommended for this type of investing are funds that have been set aside for the express purpose of high-risk investment. An individual should not invest in options with his retirement fund.

**Real Estate Investment Trusts (REIT)**
A real estate investment trust is a company that invests its assets in real estate. An individual who invests in a REIT shares in the company’s earnings and depreciation from the portfolio of real estate holdings the trust owns. Investing in a REIT provides more liquidity than investing directly in real estate, which is an advantage. A disadvantage is the lack of control the investor has when it comes to selling and managing the holdings.

An REIT is like a stock; common stocks are ownership shares of a business—usually a manufacturing concern or a service business. REIT shares represent the holding of an asset for rental instead of manufacturing a product. Because an investor in an REIT experiences a risk similar to that of a stockholder, he only realizes a profit if the REIT actually realizes a profit after expenses, interest/principal, and preferred shareholder dividends are paid. REITs are considered a conservative risk and usually experience long-term gains that are somewhat less than common stocks in other business industries.

**Promissory Notes**
A promissory note is a loan or an IOU—it’s a form of debt. A business gives an investor a promissory note in exchange for a sum of money; in essence, the exchange is a loan that promises repayment of the sum of money over a certain period of time at a set rate of interest.

Many businesses nationwide market promissory notes to individual investors as a scam, or type of fraud. The Securities and Exchange Commission (SEC) and state regulators have united to prevent the fraudulent sale of promissory notes to investors. Many promissory note scams are directed at the elderly, claiming to be “guaranteed” and to offer interest rates as high as 15%. Legitimate corporate promissory notes are not usually marketed to the public. Instead, they are marketed to sophisticated investors familiar with the appropriate methods used to research a company issuing a promissory note to evaluate the nature and scope of the investment risk. Legitimate promissory notes must be registered either with the SEC or a state regulator--or listed as exempt—and can only be sold by an individual holding a securities license.

**Limited Partnerships**
Limited partnerships are formed to complete a specific undertaking, such as build a large commercial building, create a housing development, make a movie, etc. They involve general partners—who manage the partnership and are responsible for most of its dealings, and limited partners—who invest their money in exchange for the potential to collect a significant return on their investment.
Investing in limited partnerships is a long-term venture; depending upon the type of partnership (the publicly traded Master Limited Partnership [MLP] or the privately held Direct Participation Program [DPP]), taxation and access to cash flow varies. MLPs are often used to gain current income while deferring taxes. Pensions, endowments, IRAs, and 401(k) plans are not permitted to own MLPs because the cash distributions received are considered unrelated business taxable income. The best way to invest in a limited partnership is through a brokerage account.

These vehicles may be risky—depending upon the partners involved in the venture—and are often difficult to sell if they’re privately owned. As with some of the other types of investment vehicles we discussed, funds used for a limited partnership should be set aside expressly for this purpose and not taken from assets needed to meet current or future expenses.

*Viatical Settlements*

A viatical settlement involves the purchase of a life insurance policy for less than its face amount and the buyer receives the full death benefit at the insured person’s death. The longer the life expectancy of the insured, the less expensive the policy.

A number of risks exist with this type of investment:

- What if the terminally ill insured lives longer than predicted by the viatical table?
- What if the terminally ill insured outlives the premium funds in escrow?
- What if the life insurance policy is within the contestable period?
- What if the contract presented to the investor is not a legitimate policy?
- What if the seller is not authorized to broker a viatical settlement? (most states regulate these transactions)
- What if the physician declaring the terminal illness is not a practicing physician?
- Is the individual investing in the purchase of one policy or in a pool of policies?

**SUMMARY**

Each investment vehicle has positives and negatives, advantages and disadvantages. Most investors are willing to exchange some degree of risk for the possibility of a reward. It is the producer’s responsibility to legitimately evaluate the advantages and disadvantages of all viable investment vehicles, and present them to the consumer while considering the consumer’s needs, financial situation, goals, current and future income requirements, investment objectives, risk tolerance, and a myriad of other factors.
CHAPTER 8 – REVIEW QUESTIONS

Answers are in the back of the text

1. All of the following are advantages of annuity contracts EXCEPT _____.
   [a] Tax-deferred growth of principal and interest
   [b] No minimum contribution limits
   [c] No step-up basis at death
   [d] Appropriate for a long-term investor

2. _____ is considered a safe and secure investment.
   [a] Stock
   [b] Money market account
   [c] Commodities
   [d] Promissory note

3. A viatical settlement involves _____.
   [a] The purchase of a life insurance policy for less than its face amount
   [b] The purchase of a life insurance policy for more than its face amount
   [c] The purchase of a Master Limited Partnership (MLP)
   [d] The purchase of a Direct Participation Program (DPP)
Chapter 9

Sales Practices for California Insurance Agents

INSURANCE PRODUCER RIGHTS AND OBLIGATIONS AT CONTRACT INCEPTION

In 1905, vast media coverage depicted extravagant spending and political payoffs by executives of the Equitable Life Assurance Society at the expense of its policyholders. The media frenzy prompted the New York state insurance commissioner to launch an investigation into the allegations and a special committee was created to investigate the practices of all life insurance companies within the state.

Two years later, the Armstrong Committee’s report was submitted to the New York state legislature and cited such confirmed abuses as unlimited company expenses, excessive lobbying expenses, rebating, encouragement of policy lapses, twisting, proxy voting to frustrate policyholder control of mutual insurance companies, and the creation of subsidiary financial institutions to evade restrictions on investments. As a result of the offenses cited in the report, the New York State legislature issued a series of strict insurance regulations for the protection of the consumer. Other soon states followed suit.

Insurance regulations still exist today for the protection of the consumer. Licensed insurance producers are required by California Insurance Coded (CIC) to disclose specific information to the consumer when attempting to sell an annuity and at the inception of the contract. When using illustrations to describe life insurance and annuity contracts, producers must adhere to guidelines to assure that the consumer is provided with all the information he needs to make an informed buying decision. In addition, insurance code stipulates certain procedures when the replacement of an annuity contract is involved and for allowing the consumer a “free look” period, which begins at the time of delivery of the contract, and provides for a specific time period for the consumer to review the contract and change his mind about the purchase. The importance of a producer actually reviewing existing contracts to be replaced, and sample contracts to be sold, cannot be stressed enough. Annuity contracts are legally binding; because of their complexity and the fact that they are not suitable for everyone, it is essential that a consumer understand all aspects of the vehicle into which he will be contributing a substantial sum of money.

DISCLOSURE

In addition to other disclosures required by code, the state of California contains specific requirements for disclosure to seniors with respect to the sale of any life insurance or annuity product. A senior, or “elder,” is defined in code as any California resident who is 65 years of age or older; for purposes of the replacement, this age is 60 or older.
Because the number of seniors in our country is growing at a rapid rate, this segment of the population is often a target of financial fraud and predatory sales practices. Annuities are attractive to seniors because they offer a predictable stream of income and, quite often, seniors find themselves confused when faced with the variety of available options. Some salespeople, however, either sold inappropriate annuities to seniors in order to earn themselves large commissions or deliberately failed to disclose surrender charges and other annuity features for other purposes. According to Consumer Affairs, The California Attorney General and California Insurance Commissioner filed suit in 2005 against one group that tricked senior citizens into using their retirement investments to buy annuities that often made less sense for their elderly victims. Nationwide, a number of class-action lawsuits have been filed for “senior fraud” and many states have enacted legislation for the protection of seniors.

According to the Gallup organization’s survey in 2009, the typical owner of an annuity is a retired woman in her early seventies. She is college educated with a family income of between $50,000 and $75,000 and she purchased her annuity when she was in her fifties. Gallup’s statistics show that only 8% of the people who purchased non-qualified annuities in 2008 were 54 years old and younger.

The 2009 Annuity Fact Book, published by the Insured Retirement Institute, indicates the following perspectives of annuity owners aged 64 and older, nationwide, with respect to their reason for purchasing annuities:

- Financial cushion in case their spouse lives beyond life expectancy (84%)
- Financial resource to avoid being a financial burden on their children (83%)
- Providing retirement income (73%)
- Providing an emergency fund in the event of a catastrophic illness or required nursing home care (76%)
- Financial protection in the event other investments perform poorly (69%)

The 2009 Annuity Fact Book also reports that retired annuity owners indicate the following data concerning their sources of retirement income; the percentages shown represent the segment of the retired population receiving income from the source cited:

- Employer funds in their retirement plans (48%)
- Annuity owner’s funds in their retirement plans at work (25%)
- Social Security (58%)
- Personal savings, annuities, investments (26%)
- Full-time or part-time employment (8%)
- Sale of home, farm, or business (10%)
- Support from children or other family members (1%)

As can be seen in the preceding citations, the reasons people—and especially seniors—purchase annuities vary greatly, as do the sources of income of the purchaser. Because of the wide array of contributing factors and needs of the consumers seeking to purchase annuities, the need for full disclosure of all facts pertaining to annuity contracts has never been as important as it is today.
Nationwide, variable annuity sales decreased in 2008, as did the number of insurance companies selling them. Individual fixed annuity sales, on the other hand, increased 50% in 2008, largely due to competitive interest rates and the requirement of consumers that their retirement products offer safety and guarantees. A producer MUST know and understand the annuity products he sells, along with all their features, uses, and the consequences of their purchase with respect to the needs and circumstances of each individual to whom he sells an annuity.

In the state of California, if a senior is contemplating the sale or liquidation of an asset prior to purchasing a financial product, the producer must provide in writing to the elder or the elder’s insurance agent a statement indicating that selling or liquidating any stock, bond, Individual Retirement Account (IRA), certificate of deposit (CD), mutual fund, annuity, or other asset for the purpose of funding any life insurance or annuity product may result in a taxable event, early withdrawal penalties, or other costs and charges resulting from such sale or liquidation. The written notice must also contain the suggestion that the elder or the elder’s insurance agent seek independent legal or financial advice before selling or liquidating any assets prior to purchasing any life insurance or annuity being considered. Many seniors do not fully understand the consequences of surrendering a life or annuity contract, or selling/liquidating other assets. They tend to trust their insurance agents and other advisors and seldom seek the advice of family members and professionals for fear of appearing frail, uninformed, or incompetent. The state of California requires such a disclosure so seniors can be assured that seeking the advice of others is actually encouraged and is not viewed as a weakness.

A producer is prevented, by law, from selling or offering for sale a financial product to an elder, including an annuity, on the basis of that product’s treatment under the Medi-Cal program (California’s Medicaid program) by negligently misrepresenting the treatment of any asset under the statutes, rules, and regulations of the Medi-Cal program with respect to the elder’s eligibility for any program of public assistance. If a producer offers for sale any financial product, including an annuity, based on its treatment under the Medi-Cal program, a specific disclosure must be provided, in writing, to the elder or the elder’s insurance agent. That disclosure appears below and must be printed in at least 12-point type, must be separate from any other document, and must be signed by the applicant, the applicant’s spouse, and any applicable legal representative:

“NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY AND RECOVERY
If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message! You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

RECOVERY
An annuity purchased on or after September 1, 2004, shall be subject to recovery by the state upon the annuitant's death under the regulations of the Medi-Cal Recovery Program. Income derived from the annuity must be used to meet the annuitant's share of costs and, if the annuitant is married, the income derived from the annuity may impact the minimum monthly maintenance needs of the annuitant's community spouse. An annuity purchased by a community spouse on or after September 1, 2004, may also be subject to recovery if that spouse is the
recipient of past or future Medi-Cal benefits.

UNMARRIED RESIDENT
An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources. The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

Community Spouse Resource Allowance: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

Minimum Monthly Maintenance Needs Allowance: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS
Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance needs allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS
Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

One Principal Residence: One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home some day. The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it. Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

Real Property Used in a Business or Trade: Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS: These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

Personal Property Used in a Trade or Business
One Motor Vehicle
Irrevocable Burial Trusts or Irrevocable Prepaid Burial Contracts

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.
This is only a brief description of the Medi-Cal eligibility rules. For more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney who is not connected with the sale of this product.
I have read the above notice and have received a copy.

Dated: _______________ Signature: _________________________________________

**ILLUSTRATIONS**

If an insurance company or insurance producer sells or delivers an annuity to a senior in the State of California using illustrations that discuss values that are not guaranteed, and the illustration is not a pre-printed illustration provided by the insurance company, a specific disclosure must be contained on the illustration as follows:

- In bold or underlined capitalized print, or
- In a sticker of a contrasting color, or in highlighted text, or in any manner that makes it more prominent than the surrounding text, and
- With at least one-half inch of clear space on all four sides, and which reads:
  - This is an illustration only. An illustration is not intended to predict actual performance. Interest rates, dividends, or values that are set forth in the illustration are not guaranteed, except for those items clearly labeled as guaranteed.

If a pre-printed illustration is used, the same disclosure appearing above must be contained either on the illustration or on an attached cover sheet in 12-point bold print with the same one-half inch of clear space on all four sides of the notice. In addition, the pre-printed illustration must show guaranteed values in bold print and all other values must appear in standard print. (Values include cash values, surrender values, and death benefits.)

**REPLACEMENT**

Cancelling or surrendering an annuity contract for the purpose of exchanging or replacing it for a new contract is not always in the best interests of the consumer. Most producers handle the replacement of annuity contracts in a legal and ethical manner. In order to protect consumers from the occasional dishonest practitioner, California has (as have most other states) enacted legislation concerning the replacement of life insurance and annuity products.

When a producer completes an application for the sale of an annuity, he must sign a statement that becomes part of the application indicating whether replacement is—or may be—involved in the transaction. If replacement is, or may be, involved, the producer must supply the insurance company with the following information:

- A list of all policies to be replaced, including policy numbers, insurance company names, and insured persons
- A copy of the replacement notice required by CIC

Within three business days of the proposed insurance company’s receipt of the signed annuity application, or the date the annuity contract is issued—whichever occurs first, the
insurance company must then send written communication to the insurance companies of the existing policies; the written communication must contain the following:

- A notice that replacement of the policy or policies is anticipated
- Identification information concerning the existing policy/policies to be replaced
- A policy summary, ledger summary, or ledger statement containing policy data on the proposed annuity contract

The insurance companies of the existing policies must send to the policy owner, within twenty days of their receipt of the written communication concerning replacement, policy summaries or ledger statements containing policy data about the existing policies. Information relevant to premiums, cash values, death benefits, and dividends on the existing policy must be calculated from the current policy year. The policy summaries and ledger statements must also include the amounts of any outstanding loans or indebtedness, dividend accumulations or dividends, and any other information that does not violate statute.

When the replacement policy is issued, the insurance company must provide written notice, either in the policy or on a separate document, stating that the applicant has the right to an unconditional refund of all premiums paid; this right begins on the date of policy delivery and must be exercised within thirty (30) days.

The replacement of any insurance or annuity contract should be carefully considered by all parties and any recommendations to replace a contract should be accompanied by the appropriate replacement forms and suitability documentation.

**Free Look Period**

Because CIC requires insurance producers to leave with the applicant a copy of all printed materials used for presentation of the annuity, a statement signed by the producer indicating whether he knows if replacement is or may be involved in the transaction, in addition to other disclosures and forms, the consumer has ample opportunity to review facts pertinent to the annuity purchase--after the sale and before delivery and acceptance of the contract. The consumer also has the opportunity to present materials provided by the producer for review to his attorney, CPA, financial advisor, and anyone else of his choosing.

CIC also includes requirements that an insurance producer provide a senior with twenty four (24) hours’ advance written notice before visiting in the senior’s home for the purpose of attempting to sell, or selling, an annuity contract. In addition, the producer must disclose to the senior his name and professional title, and the names and professional titles of all people visiting the senior for the purpose of selling, or attempting to sell, an annuity. The name of the insurance company represented by the producer must also be provided to the senior.

Every life insurance and annuity policy contains a provision stating that the owner of the
policy or annuity may return it for cancellation and a full refund within a certain period of
time. Return of the policy for the cancellation must be made either through the mail to
the insurance company or directly to the agent from whom it was purchased. The Free
Look period can be no less than 10 days and no more than 30 days. **The Free Look
period is 30 days when replacement of an annuity contract is involved or if an
annuity is sold to a senior.** Each policy delivered to an individual aged 60 or older must
contain the Free Look notice in a font no smaller than uppercase 10-point type on the
cover page of the policy and on the outline of coverage.

All individual annuity contracts, except variable annuities, that are delivered or issued for
delivery in the state of California must have the following notice printed on the policy
cover page, policy jacket, or on a sticker that has been affixed to the policy cover page or
jacket, in 12-point bold-faced type:

"**Important: You have purchased a life insurance policy or annuity contract.**
Carefully review it for limitations. This policy may be returned within 30 days
from the date you received it for a full refund by returning it to the insurance
company or agent who sold you the policy. After 30 days, cancellation may result
in a substantial penalty, known as a surrender charge."

If the policy does not contain cancellation penalties or charges, the last sentence may be
omitted from the notice.

All individual variable annuity contracts require a notice, subject to the same terms as
stated in the previous introductory paragraph, that states:

"**Important: You have purchased a variable annuity contract (variable life
insurance contract, or modified guaranteed contract).** Carefully review it for
limitations. This policy may be returned within 30 days from the date you
received it. During that 30-day period, your money will be placed in a fixed
account money-market fund, unless you direct that the premium be invested in a
stock or bond portfolio underlying the contract during the 30-day period. If you
do not direct that the premium be invested in a stock or bond portfolio, and if you
return the policy within the 30-day period, you will be entitled to a refund of the
premium and policy fees. If you direct that the premium be invested in a stock or
bond portfolio during the 30-day period, and if you return the policy during that
period, you will be entitled to a refund of the policy’s account value on the day
the policy is received by the insurance company or agent who sold you this policy,
which could be less than the premium you paid for the policy. A return of the
policy after 30 days may result in a substantial penalty, known as a surrender
charge."

If the policy does not contain surrender charges, the last sentence may be omitted from
the notice.

Return of the annuity contract for cancellation within the Free Look period requires the
insurance company to void the policy from its inception so that the parties to the contract
are in the same position as if no policy had been issued OR to refund the full contract
value to the consumer.
APPROPRIATE ADVERTISING

Words are powerful tools: they not only communicate our thoughts, wishes, and expectations, they are used to encourage other people to act. Think about nationwide marketing campaigns that use words to convey a message about a particular business: *Have it Your Way* (Burger King), *Reach Out and Touch Someone* (AT & T), and *Don’t Leave Home Without It* (American Express).

Sometimes, words communicate information other than as intended—different perceptions, understandings, languages, and other factors impact how a message is sent and received. On occasion, words are deliberately manipulated to distort a message for the benefit of the person sending the message. Because misrepresenting an annuity contract or its benefits, values, and features is harmful, CIC includes guidelines for advertising.

The producer license number of every individual licensed to sell insurance in the State of California, and the word “insurance,” must be displayed on every business card, piece of stationery, advertisement, or illustration, price quote, or proposal that is to be distributed exclusively in the State of California. The type size of the license number and word “insurance” can be no smaller that that used for the producer’s address, telephone number, or fax number. If a producer is working as a solicitor, as an employee of a motor club, the organization’s producer license may be displayed.

All business cards, stationery, advertisements, and illustrations must also have the written approval of the insurance company if used by a licensee for the purpose of advertising a policy of insurance sold by that insurance company. No licensee may solicit a particular class of business by using misleading advertisements that indicate members of that class of business are entitled to a group or other discount when the policy is actually sold as an individual policy without discounts or reduced rates.

The same advertising requirements listed above for business cards, stationery, advertisements, and illustrations applies to the advertising and marketing materials for any seminars, classes, and informational meetings to be conducted by a licensee. If insurance products will be offered for sale at a seminar, class, or informational meeting—or other gathering of a similar type—the phrase “and insurance sales presentation” MUST be printed immediately following the word(s) seminar, class, informational meeting or other similar word or phrase.

When acquiring a senior person’s name and contact information from a lead-generating service, the producer must reveal this fact during the initial contact with the senior and any marketing or advertising materials, including direct mailers, will disclose that the agent may contact the applicant in the future for the purpose of discussing the sales of insurance and/or annuity contracts.

Advertising regulations do not apply to individuals who are not required to be licensed or who are exempt from licensure; neither do regulations apply to non-resident producers representing an insurance company that is a direct response provider.
Any person violating this section of CIC is subject to the following penalties and fines:

- Fine of $200 for the first offense
- Fine of $500 for the second offense
- Fine of $1,000 for the third and subsequent offenses
- The penalty may not exceed $1,000 for any single offense

The penalty is not imposed for each piece of printed material that violates CIC and, if the insurance commissioner determines that the licensee failed to comply with code because of reasonable cause, because of circumstances beyond his control, or after exercising ordinary care not to violate code, the commissioner may relieve the licensee of any penalty or fine.

**SPECIFIC ADVERTISING TO SENIORS**

In California, it is illegal for a producer to use a senior designation when advertising, marketing, soliciting, selling annuities to senior citizens unless certain standards and requirements are met. In CIC, the phrase *senior designation* means any degree, title, credential, certificate, certification, accreditation, or approval that expresses or implies that a producer possesses expertise, training, competence, honesty, or reliability with regard to advising seniors on finances, insurance, or risk management.

A producer may not use a senior designation verbally, or in advertising and marketing material, unless all of the following conditions have been met:

- The producer has been granted the right to use the senior designation by the organization that issues the senior designation, and the producer is currently authorized by the organization to use the designation.
- The senior designation has been approved by the commissioner for use by producers in the sale of insurance to seniors.
- The producer has been licensed for at least four years to sell the types of insurance with which the designation is used.

Producers are not permitted to use senior designations in a manner that misleads a person as to the significance of the senior designation. Each time a producer uses a senior designation in a writing, the writing shall also contain the words "California" or "CA" next to "Insurance Agent" or "Insurance Broker Agent" and "License," and these words will be located immediately prior to the producer’s license number, in type that is in the same font and at least the same size as the type used for the senior designation.

CIC stipulates a number of conditions before a senior designation may be granted by the insurance commissioner, including the senior organization’s fulfillment of the following:

- Applicants for the designation to complete a minimum number of hours of education in topics approved by the commissioner before granting them the right to use its senior designation. The courses must be relevant to the sale of insurance to seniors.
- The organization must be exclusively an educational or certificate organization, and is not directly or indirectly involved in selling insurance, nor does it receive any
compensation from the sale of insurance.

- The organization maintains reasonable standards and procedures for disciplining its designees for improper or unethical conduct.
- Imposes reasonable continuing education requirements or other means of periodically verifying a designee’s knowledge and skill in order for designees to retain the senior designation in good standing.
- Maintains a code of ethics for its designees.
- Maintains reasonable standards and procedures to test for proper mastery of the knowledge and skill required to receive the senior designation.

Any person who grants to a California resident the right to use a senior designation that has not been approved by the commissioner, without reasonably attempting to determine whether California is one of the designee's residences, will be subject to a cease and desist order and monetary penalty pursuant to insurance code as if the person had acted in a capacity for which a license was required but not possessed. These penalties will be imposed in addition to any other disciplinary and remedial authority included in CIC.

A producer holding a senior designation that was obtained before January 1, 2009 may continue to use that designation until June 30, 2010, IF the organization that issued it meets the requirements of code and certifies in a letter to the producer that he or she has completed at least 75 hours of education in topics relevant to the sale of insurance to seniors.

PROHIBITED SALES PRACTICES

SELLING ANNUITIES FOR MEDI-CAL ELIGIBILITY

A producer is prevented, by law, from selling or offering for sale a financial product to an elder, including an annuity, on the basis of that product’s treatment under the Medi-Cal program (California’s Medicaid program) by negligently misrepresenting the treatment of any asset under the statutes, rules, and regulations of the Medi-Cal program with respect to the elder’s eligibility for any program of public assistance. If a producer offers for sale any financial product, including an annuity, based on its treatment under the Medi-Cal program, a specific disclosure must be provided, in writing, to the elder or the elder’s insurance agent. That disclosure appears below and must be printed in at least 12-point type, must be separate from any other document, and must be signed by the applicant, the applicant’s spouse, and any applicable legal representative:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY AND RECOVERY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message! You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

RECOVERY

An annuity purchased on or after September 1, 2004, shall be subject to recovery by the state upon the annuitant's death under the regulations of the Medi-Cal Recovery Program. Income derived from the annuity must be used to meet the annuitant's share of costs and,
if the annuitant is married, the income derived from the annuity may impact the minimum monthly
maintenance needs of the annuitant's community spouse. An annuity purchased by a community
spouse on or after September 1, 2004, may also be subject to recovery if that spouse is the
recipient of past or future Medi-Cal benefits.

UNMARRIED RESIDENT
An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert
amount of individual's resource allowance) in countable resources. The Medi-Cal recipient is
allowed to keep from his or her monthly income a personal allowance of (insert amount of
personal needs allowance) plus the amount of any health insurance premiums paid. The
remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT
Community Spouse Resource Allowance: If one spouse lives in a nursing facility, and the
other spouse does not live in a facility, the Medi-Cal program will pay some or all of the
nursing facility costs as long as the couple together does not have more than (insert amount
of community countable assets).
Minimum Monthly Maintenance Needs Allowance: If a spouse is eligible for Medi-Cal
payment of nursing facility costs, the spouse living at home is allowed to keep a monthly
income of at least his or her individual monthly income or (insert amount of the minimum
monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS
Under certain circumstances, an at-home spouse can obtain an order from an administrative law
judge or court that will allow the at-home spouse to retain additional resources or income. The
order may allow the couple to retain more than (insert amount of community spouse resource
allowance plus individual's resource allowance) in countable resources. The order also may
allow the at-home spouse to retain more than (insert amount of the monthly maintenance needs
allowance) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS
Many of your assets may already be exempt. Exempt means that the assets are not counted
when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS
One Principal Residence: One property used as a home is exempt. The home will remain
exempt in determining eligibility if the applicant intends to return home some day. The home
also continues to be exempt if the applicant's spouse or dependent relative continues to live
in it. Money received from the sale of a home can be exempt for up to six months if the
money is going to be used for the purchase of another home.
Real Property Used in a Business or Trade: Real estate used in a trade or business is
exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS
IRAs, KEOGHS, AND OTHER WORK-RELATED PENSION PLANS: These funds are
exempt if the family member whose name it is in does not want Medi-Cal. If held in the name
of a person who wants Medi-Cal and payments of principal and interest are being received,
the balance is considered unavailable and is not counted. It is not necessary to annuitize,
convert to an annuity, or otherwise change the form of the assets in order for them to be
unavailable.
Personal Property Used in a Trade or Business
One Motor Vehicle
Irrevocable Burial Trusts or Irrevocable Prepaid Burial Contracts

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.
This is only a brief description of the Medi-Cal eligibility rules. For more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney who is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated: _______________ Signature: _________________________________________

**IN-HOME SOLICITATIONS INVOLVING SENIORS**

If an insurance producer wishes to meet with a senior in his home for the purpose of selling, or attempting to sell, an annuity, he must provide the senior with twenty four (24) hours’ advance written notice before visiting in the senior’s home. In addition, the producer must disclose to the senior his name and professional title, and the names and professional titles of all people visiting the senior for the purpose of selling, or attempting to sell, an annuity. The name of the insurance company represented by the producer must also be provided to the senior. Any misrepresentation concerning the intent of the meeting is a violation of CIC.

**COMMISSION SHARING**

A producer who is not also an active member of the State Bar of California may not share a commission or other compensation with an active member of the State Bar of California. For purposes of insurance code, “commission or other compensation” means pecuniary or non-pecuniary compensation of any kind relating to the sale or renewal of an annuity, and is not limited to a bonus, gift, prize, award, or finder’s fee.

**UNNECESSARY REPLACEMENT**

If a producer or insurance company recommends the replacement or conservation of an existing annuity contract by using a materially inaccurate presentation, illustration, or comparison of an existing contract’s premiums, benefits, dividends, or values he is violating CIC. He is also violating CIC he if recommends the unnecessary replacement of an annuity to an insured sixty-five years old or older.

CIC defines “unnecessary replacement” to mean: “the sale of an annuity to replace an existing annuity that requires that the insured will pay a surrender charge for the annuity that is being replaced and that does not confer a substantial financial benefit over the life of the policy to the purchaser so that a reasonable person would believe that the purchase is unnecessary.”

CIC further states: “Patterns of action by policy owners who purchase replacement policies from the same agent after indicating on applications that replacement is not involved, shall constitute a rebuttable presumption of the agent's knowledge that replacement was intended in connection with the sale of those policies, and such patterns of action shall constitute a rebuttable presumption of the agent's intent to violate this article.”
**Substantial Financial Benefit**

The purpose of replacing an annuity contract should be to put the consumer in a significantly better position than he was in before the replacement—not to enhance his position marginally or to generate an even exchange. The replacement should involve a contract that provides better benefits and features, a greater rate of return, lower surrender charges or a shorter surrender period, greater death benefits, and/or some combination of such improvements. The consumer should be receiving a **substantial financial benefit** and that benefit should be demonstrated before and after the replacement.

For example, let’s say Trudy is fifty-five years old and owns a deferred fixed annuity with a value of $50,000. It is earning 5% interest and the surrender term of the contract has expired. She is considering replacing her annuity with a contract that offers a return of 5.75% interest and that contains a surrender term of seven years, with the surrender penalty beginning at 7% and reducing by 1% per year. The difference in earnings between her current annuity and the proposed replacement annuity over the next ten years—assuming the interest rates don’t change—is roughly $5,000 or 10% of the current annuity values. Is $5,000 more money at retirement a substantial financial benefit? It all depends upon how likely it is that Trudy will need to access the funds in her annuity in the next seven years. If she needs to make a withdrawal, even a 5% penalty on a withdrawal of $6,000 is $3,000—more than half the additional income she’ll realize by replacing her current contract.

In a different example, let’s say the surrender term of Trudy’s $50,000 annuity has not yet expired and she’s sixty years old. She’ll have roughly $2,500 more money at retirement if she replaces her contract BUT she’ll incur a surrender charge when she cancels the current contract, reducing the amount of the additional earnings, AND she’ll incur a new surrender term in the new contract. Is that a substantial financial benefit? Probably not.

**Pretext Interviews (aka Bait and Switch)**

Bait and switch tactics are a form of false or misleading advertising and are illegal in the United States and in each of the fifty states. Bait advertising involves the offer to sell a product, or one of its features, that the advertiser does not truly want to sell. When the consumer is distracted by the “bait,” the advertiser attempts to sell something else, to obtain leads to other people, or to obtain information not pertinent to the “bait.” In the insurance industry, unethical producers often use bait and switch tactics in the form of a pretext interview to obtain information under false pretenses.

California Insurance Code (791.02(u)) defines pretext interview as: “An interview whereby a person, in an attempt to obtain information about a natural person, performs one or more of the following acts: (1) Pretends to be someone he or she is not, (2) Pretends to represent a person he or she is not, in fact, representing, (3) Misrepresents the true purpose of the interview, (4) Refuses to identify himself or herself upon request.” The growing popularity of estate planning and living trusts has generated scams called “Living Trust Mills.” These scams often target seniors, who are attracted to free seminars about estate planning, living trusts, and other similar topics. Some producers
provide themselves with official sounding titles, such as “Trust Expert,” “Trust Advisor,” “Senior Estate Planner,” and “Paralegal” and present free seminars under the pretext of helping establish or update living estates. The true purpose of these producers is to acquire the financial information of seniors they might otherwise not be able to obtain—in the form of a pretext interview.

**Long-term Care Sales**

Sales of long-term care insurance, including long-term care riders on annuity contracts, generate another area of significant pretext interviewing and bait and switch tactics. The unethical producer focuses on the consumer’s fear of contracting a serious illness, such as cancer, and uses that fear to motivate the sale of an annuity—with or without the long-term care rider. The purpose of the producer is not to benefit the client, it’s to earn himself the commission dollars generated by the sale. Long-term care riders often have terms and conditions that involve penalties for withdrawals that exceed certain amounts, limited benefit periods, and waiting periods before benefits start.

**Illegal Practice of Law**

Oftentimes, a consumer will ask a producer for advice that borders outside the producer’s area of expertise, such as with accounting and legal matters. It is illegal in most states, and especially in the state of California, for a producer to offer any type of legal advice without being licensed to practice law. Section 6125 of the California Business and Professions Code states: “No person shall practice law in California unless the person is an active member of the State Bar.”

If the producer is questioned about any topic related to insurance that deals specifically with estate planning, elder care planning, Medi-cal planning, and tax planning should be referred to the appropriate professional for consultation and advice.

**Suspension of Producer Licenses**

Because of the state of California’s concern with elder abuse, which we will discuss in the next chapter, and any unethical and illegal conduct pertaining to the solicitation or sale of insurance in this state, CIC considers all of the following acts and practices to be grounds for the suspension or revocation of any insurance license issued:

- The licensee induced a client, whether directly or indirectly, to cosign or make a loan, make an investment, make a gift, including a testamentary gift, or provide any future benefit through a right of survivorship to the licensee, or to any of the persons listed below (and following the [***] symbol)
- The licensee induced a client, whether directly or indirectly, to make the licensee or any of the persons below (and following the [***] symbol) a beneficiary under the terms of any living (inter vivos) or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy
- The licensee induced a client, whether directly or indirectly, to make the licensee, or a person who is registered as a domestic partner of the licensee, or is related to the licensee by birth, marriage, or adoption, a trustee under the terms of any living (inter vivos) or testamentary trust; if the licensee is also licensed as an attorney in
any state, the licensee may be made a trustee under the terms of any inter vivos or testamentary trust, provided that the licensee is not a seller of insurance to the trustor of the trust

• The licensee, who has a power of attorney for a client, sold to the client or used the power of attorney to purchase an insurance product on behalf of the client for which the licensee has received a commission

[***] The first two bullet points appearing above also apply if the licensee induces the client to provide the benefits in those subdivisions to the following people:

• A person who is related to the licensee by birth, marriage, or adoption
• A person who is a friend or business acquaintance of the licensee
• A person who is registered as a domestic partner of the licensee
• This section DOES not apply to situations in which the client is:
  o A person related to the licensee by birth, marriage, or adoption, or
  o A person who is registered as a domestic partner of the licensee

**Penalties for Violations of CIC**

When an insurance producer violates California Insurance Code, certain penalties and fines may be charged, in addition to any other administrative penalty or loss of license.

*Misrepresentation of Any Policy or its Benefits and/or Dividends*

Any person who misrepresents, in any fashion, an insurance contract or its benefits and/or dividends is subject to a fine of up to $25,000. If the victim’s loss exceeds $10,000, the fine may equal an amount that is no more than three times the loss of the victim, imprisonment in county jail for up to one year, or by both a fine and imprisonment. Restitution to the victim, per the CA Penal Code, must be made before a fine is collected by the CIC.

If a person makes any misrepresentation of a policy, its benefits, and/or dividends for the purpose of inducing another person to purchase a policy, to refuse to accept a policy that has been issued, or to lapse or forfeit or surrender a policy, the penalties stated above also apply.

*Violations Pertaining to Seniors*

If a person is alleged to have perpetrated senior abuse, a hearing must be held within 90 days of the insurance department’s receipt of such notice and the hearing may only be postponed for those circumstances listed in CIC 1738.5, which include the death or incapacitating injury of the person, lack of notice of hearing, a material change in the status of the case, and a few other circumstances.

Insurance companies must issue refunds to seniors who exercise their rights under the 30-day Free Look period in a timely manner. If they fail to issue refunds in a timely manner, insurance companies will owe the contract holder interest beginning on the date the policy was returned to the insurance company or producer.
Any producer who violates insurance code with respect to the sale of insurance to seniors is subject to administrative authority by the insurance commissioner, which includes penalties of no less than $1,000 for the first offense and no less than $5,000 for a second or subsequent offense; the maximum penalty for a second or subsequent offense is $50,000. In addition, the insurance commissioner may suspend the producer’s license if the outcome of a hearing indicates the producer could have reasonably been expected to cause significant harm to seniors.

If an insurance company violates this section insurance code concerning seniors with a frequency that indicates a general business practice, or commits a knowing violation of this article, he will be liable for an administrative penalty of no less than $30,000 and no more than $300,000 for each violation. In addition, an administrative penalty of up to $10,000 for the first violation may be assessed to an insurance company.

In addition to any administrative penalty, fine, or imprisonment that is imposed, the insurance license of any person or entity is subject to suspension or revocation for violating California Insurance Code.

**SENATE BILL 483: MEDI-CAL HOME AND FACILITY CARE**

The California Medi-Cal program, which is administered by the State Department of Health Care Services, provides health care services to qualified low-income recipients—it is the state’s Medicaid program. Previous law established various criteria for eligibility for Medi-Cal benefits; benefits included nursing facility services and home- and community-based services. This bill required any applicant for, or recipient of, Medi-Cal benefits who requests medical assistance for home and facility care, as defined, to meet the specific eligibility requirements for the receipt of medical assistance for home and facility care.

Changes to the California Welfare and Institutions Code, per SB 483, include:

- The addition of Section 14006.16 under SEC. 4 concerning “equity interest,” which is defined as the lesser of the assessed value of the principal residence determined under the most recent tax assessment, less any encumbrances of record or the appraised value of the principal residence determined by a qualified real estate appraiser who has been retained by the applicant or beneficiary, less any encumbrances of record. This section does NOT apply to an individual if any of the following circumstances exist:
  - The spouse of the individual or the individual's child—who is under 21 years of age, blind, or disabled—is lawfully residing in the individual's home
  - The individual was determined eligible for medical assistance for home and facility care based on an application filed before January 1, 2006
  - The department determines that ineligibility for medical assistance for home and facility care would result in demonstrated hardship on the individual. For purposes of this section, demonstrated hardship includes, but is not limited to, any of the following circumstances:
    - The individual was receiving home and facility care prior to January
The individual has been determined to be eligible for medical assistance for home and facility care based on an application filed on or after January 1, 2006, and before the date that regulations adopted pursuant to this section are certified with the Secretary of State.

The individual purchased and received benefits under a long-term care insurance policy certified by the department's California Partnership for Long-Term Care Program, established by Division 12 (commencing with Section 22000).

The individual's equity interest in the principal residence exceeds the equity interest limit as provided in subdivision (b), but would not exceed the equity interest limit under that subdivision if it had been increased by using the quarterly House Price Index (HPI) for California, published by the Office of Federal Housing Enterprise Oversight (OFHEO).

The applicant or beneficiary has been denied a home equity loan by at least three lending institutions, or is ineligible for any one Federal Housing Administration (FHA) approved loan or reverse mortgage.

The applicant or beneficiary, with good cause, is unable to provide verification of the equity value.

The applicant or beneficiary meets the criteria set forth in subdivision (b) of Section 14015.1.

**SUITABILITY IN ANNUITY SALES**

Annuities are complex financial contracts that do not meet the needs of all consumers. Annuity producers are required by both ethical and legal constraints to confirm, before the sale, that the purchase of an annuity is in the best interests of their clients and that they can show “reasonable grounds” for the appropriateness, or suitability, of recommendations made to clients.

Annuities are intangible products that cannot be evaluated using the same methods utilized to assess tangible products. The value of an annuity is often difficult for a client to grasp—especially a senior. The annuity contract is, by necessity, filled with legal terms, exceptions, and contingencies and the average consumer is not equipped to understand them, so he places his trust in the professional recommending and selling the product. This trust is usually well deserved; however, the opportunity for producers misleading or deceiving consumers exists. Suitability requirements were established for the protection of consumers and, specifically, to prevent individuals from entering into contracts that are not appropriate for their particular situations and needs.

During the past several years, insurance regulators have been monitoring complaints from consumers concerning annuity sales. According to Kansas Insurance Commissioner, Sandy Praeger, who addressed the Senate Select Committee on Aging in September...
2007, the total number of annuity complaints remains low when compared to other lines of insurance. The number of complaints is still significant, however, and indicates a troubling trend.

In the states that reported data on annuity sales to the National Association of Insurance Commissioners (NAIC), the period from 2004 through 2007 experienced a marked increase in the number of total complaints in the categories of suitability, agent handling, and misrepresentation. The total number of complaints reported in these categories rose from approximately 1400 in 2004 to more than 2300 in 2006. The proportion of these complaints attributed to suitability issues also increased each year—from just over 10% in 2005 to more than 18% in 2007. Each complaint is reviewed and investigated by the respective state Department of Insurance and, since 2004, more than 75% of the annuity complaints reported to the NAIC by state regulatory agencies have been resolved in favor of the consumer.

In light of the rising number of complaints about annuity sales, the NAIC adopted a white paper in 2006 that called for the development of suitability standards for non-registered annuity products similar to those that existed under the Securities and Exchange Commission (SEC) regulations for registered products. The white paper resulted in the creation of a working group under the NAIC Life Insurance and Annuities Committee; that group drafted a model regulation establishing suitability standards for all life insurance and annuity products.

The committee decided to focus first on the area identified as subject to the greatest abuse: the inappropriate sales of annuities to persons over the age of 65. The resulting Senior Protection in Annuity Transactions Model Regulation (Suitability Model) was adopted by the NAIC in 2003. This model is another tool regulators use to protect consumers from inappropriate sales practices.

Purchasing life and annuity products is often a complicated and confusing process for consumers of all ages, not just for seniors, and most regulators believed the protections of the Suitability Model should be extended to other segments of the population. The NAIC membership addressed this issue in 2006 by adopting revisions to the Suitability Model so that its requirements apply to all consumers, regardless of age. As of June 10, 2009, thirty-five states adopted the NAIC Suitability Model or similar suitability regulations. The most recent draft of the Suitability Model is dated December 1, 2009.

The Suitability Model spells out duties of insurance companies and insurance producers with respect to recommending the purchase or exchange of an annuity that result in an insurance transaction (or a series of insurance transactions). The duties require the producer (or the insurance company if no producer is involved) to document his reasonable grounds for believing the recommendation to the client is suitable based on facts obtained by the client and which include:

- Potential surrender term and surrender charges,
- Potential tax consequences and penalties if the consumer sells, exchanges, surrenders, or annuitizes the contract,
• Mortality and expense fees,
• Investment advisory fees,
• Potential charges for, and features of, riders,
• Limitations on interest returns,
• Insurance, and
• Investment components and market risk

If a state has adopted the Suitability Model, the requirements listed above are intended to supplement, not replace, the disclosure requirements. The Suitability Model also requires producers to possess adequate knowledge of annuity products before making recommendations to consumers and to comply with regulation concerning product-related training and continuing education. These requirements include familiarity with not only the annuity contracts themselves, but California law concerning suitability, disclosure, preparation and dissemination of illustrations and prospectuses, replacement, advertising, direct mailers, prohibited sales practices, special laws concerning seniors, comparison between the types of annuities, and policy cancellations and refunds.

Because of the complicated nature of annuities, California Insurance Code (CIC) requires producers to complete eight hours of continuing education on the subject of annuities before being able to sell them. In addition, CIC requires producers selling annuities to complete four hours of continuing education about annuities every license renewal period. A producer who is familiar with an insurance product is far more likely to make appropriate recommendations to the consumer than is a producer with little or no knowledge of the same product.

Making an informed decision before purchasing or exchanging an annuity requires a consumer to understand, and the producer to explain, a great deal of technical information: the complexity of the various annuity contract provisions and features, the impact of state and federal taxation on annuity payouts, and the uncertainty of numerous factors affecting the consumer’s assets, needs, and longevity. As is the case with many insurance transactions, a client purchasing or exchanging an annuity will seldom recall each detail of the qualification process or the particulars of each conversation with the producer. It is essential for us, as annuity producers, to conduct every step of the suitability determination not only for the purpose of establishing “reasonable grounds,” but also to use the information for future evaluations of a client’s financial picture.

As products develop and acquire new uses, as federal and state tax laws change, and as our life expectancy stretches beyond previous prospects, the need for the producer’s attention to focus on all manner of detail and responsibility with respect to the sale of annuities continues to grow.

**INFORMATION COLLECTION**

Each consumer has his own unique financial situation and personal needs, as well as an individual perspective about where he plans to be, in a financial sense, at retirement and beyond. Before an annuity producer can make appropriate recommendations, many
details about the prospective client and his situation must be ascertained and evaluated. This process may encompass several meetings and the review of a number of insurance policies, annuity and investment contracts, and other documents.

Personal information about the consumer must be reviewed, including age, gender, marital status, the existence of dependents, and the life stages of any dependents. It is also necessary to collect personal information about the prospective client’s spouse and dependents. Other personal information essential to the suitability evaluation include the prospective client’s investment objectives, risk tolerance, current financial state of affairs, and the existence of other types of annuities, insurance, retirement accounts, and investment vehicles.

Because of the sensitive nature of much of the information required to perform a thorough suitability evaluation, an annuity producer should always comply with state and federal regulations concerning the collection and security of non-public, private information. In order to earn and retain the trust of consumers, as well as to facilitate the process of collecting required information, producers should volunteer their familiarity with privacy regulations, make all required disclosures, and respect the consumers’ right to privacy.

**Financial Status of the Consumer**

The consumer’s current financial situation includes information related to his current annual income, assets, liquidity, future financial concerns, medical and long-term care concerns, anticipated age of retirement, financial support of family members, intended use of the annuity, and sources of funding for the annuity. No recommendations about the purchase of an annuity—or any other insurance product—should be made until this financial information is carefully reviewed and assessed.

**Current Annual Income**

The consumer’s annual income and other sources of income are important elements of the suitability evaluation. Some consumers simply do not possess the financial resources to fund their retirement goals in a fashion they envision. Some retirement plans and financial institutions withhold estimated taxes on income as a convenience for the consumer; others do not. If estimated taxes are already being withheld from the consumer’s income, the consumer and producer need to determine if the amounts withheld have been adequate in previous years. If, in the past, the consumer has been required to pay additional taxes at year-end, this factor will indicate an annual need for liquidity. If no taxes are withheld from some, or all, of the consumer’s income stream, the need for liquidity at tax time will be even greater.

The nature of the consumer’s annual income is also important to determine as well as the history of the income stream versus inflation. If the consumer is currently working and earning income, any predicted changes in future earnings should be taken into account. If the income tends to fluctuate, the nature and details of the fluctuation also need assessing and documentation. Another important element of the income stream is its ending point. For example, if the consumer sold a piece of real estate and owner-financed the sale, the
fact that the payments will end in five years (because the term of the loan will end) is an important factor to consider.

**Assets**
Information should be collected about all the consumer’s assets, including investments. Some consumers possess many assets and because their value, on paper, is significant, a consumer may believe he is in a better position to fund an annuity than he really is. As stated in the previous chapter, a producer must caution a consumer about not contributing too much of his liquid assets into an annuity. We’ll discuss this topic in the next section about liquidity.

Details obtained about the consumer’s assets should include:
- Type of asset
- Current value
- Purchase/acquisition date
- Intended use
- Tax status (qualified or non-qualified)
- Type of ownership (single, joint, trust, etc.)
- Current income generated by the asset, if applicable
- Length and amount of any mortgage or loan pertaining to any real or personal property

**Liquidity**
Since annuities impose surrender charges the current and future liquid resources and needs of the consumer should be a major consideration in determining annuity suitability. A big issue with annuity sales is overselling an annuity. Overselling is taking a situation where an annuity makes sense for the consumer but the agent recommends that too much of their assets be put into an annuity. When an annuity is oversold, the consumer often finds himself needing cash for some reason and the only place he can turn (short of borrowing) is to the annuity which may still be within the surrender charge period.

While some of the recommendations listed below are not specifically required by California law, they are submitted as additional measures to forecast future needs for liquidity and explore areas that may result in future needs for liquidity that may not be readily apparent to most consumers. Following these recommendations may ultimately result in a smaller annuity sale but should also result in a more thorough analysis of potential future needs for liquidity.

The consumer’s liquid net worth should represent only the net value of assets after being converted to cash. Assets such as real estate (including the principal residence) should not be included in a liquid net worth calculation because of the speculative nature of the sale of the real estate. Other assets, such as automobiles and household belongings, should not be included as liquid assets even if they could be sold with relative ease because they are utilized in the consumer’s daily life and are not likely to be sold. If liquidation of an asset involves imposition of a surrender charge or other penalty, only the net value after imposition of the surrender charge or penalty should be considered.
If an asset is exposed to market risks, the future amount available for liquidity is difficult to gauge. Additionally, if the consumer or his spouse is not yet 59 ½ years old (where one spouse is 65 or older and the other is younger), the qualified retirement assets should not be counted as liquid due to the 10% early withdrawal penalty. Another consideration is the required minimum distribution requirement at age 70 ½. If the consumer is subject to this requirement, he should have sufficient retirement assets available for liquidation without penalty, surrender charge, or market risk to comply with the required distributions. Laddering of assets over time is a good strategy for providing future liquidity. It involves projecting liquidity needs into the future and determining which assets will provide that liquidity stream without penalty, surrender charge, or potential market loss.

**Long-term Care Concerns**

The soaring costs of health care, and the potential inability of the consumer to afford future health care costs, is a concern for many consumers. Consumers aged 65 and older usually rely on Medicare Parts A and B to form the base of their primary health care delivery program. In addition, they should also consider Medicare Supplement coverage, as well as Medicare Part D to gain access to prescription drug coverage. In the case of a senior couple where one is not yet 65, the couple needs to have a strategy in place to obtain affordable health care for the younger spouse until Medicare eligibility is attained. The potential costs for custodial care should not be overlooked and are often addressed by the purchase of a Long-term Care policy. With California’s Long-term Care Partnership program, the senior consumer should investigate the viability of insuring this risk. If a senior consumer needs long-term care services and does not have coverage, even the most sophisticated of financial plans can be devastated.

**Tax Status**

The producer needs to be aware of the consumer’s tax filing status (i.e. married, head of household, single, qualifying widow, etc.). The producer also needs to know if any taxes are in arrears. The consumer’s tax status during the accumulation period of an annuity, and his projected tax status when distributions begin, has a significant impact on his decision to purchase an annuity—especially if he finds himself in the position of needing to prematurely surrender the annuity or take early distribution.

Another consideration concerning tax status is the existence of other retirement and investment vehicles. For example, if a consumer has a 401(k) or other pre-tax retirement plan, he should verify that he is making maximum contributions to those plans before purchasing an annuity. In addition, it is essential to inform the consumer that taxes are imposed for withdrawal of funds (other than the 10% window) from a qualified annuity before age 59 ½ and upon commencement of the required withdrawals beginning at age 70 ½. A discussion of taxation on the growth in an annuity as *ordinary income* instead of as *capital gains* should also be conducted with the consumer.

**Investment Objectives**

The producer needs to obtain information from the consumer about his investment objectives. Oftentimes, the consumer may not have a clear understanding of his objectives. Significant discussion and numerous follow up questions may be a crucial
part of the suitability evaluation before determining that the consumer truly understands and articulates her investment goals.

The timing and amount of future access to the intended funds should be calculated to the best of the client’s ability. This is a good time to question the need for, and existence of, an emergency fund, along with other unexpected contingencies that may arise between the current time and the consumer’s projected retirement date. It is especially helpful to consumers who do not have a clear and vivid picture of their goals and objectives at the outset of the suitability evaluation for the producer to not only listen carefully to the consumer’s statements but also to repeat back the producer’s understanding of what was said. Because of the intangible nature of annuities, and the lack of a visible product or means to display the use and implementation of them, discussing the product from different perspectives and for different purposes provides the consumer with an additional opportunity to sharpen the focus of her goals.

Most insurance companies require producers to use some form of questionnaire to help determine risk tolerance. This completed questionnaire is then retained by the insurance company to show that an attempt was made to accurately gauge the consumer’s risk tolerance. Generally speaking, the more likely the product is to expose the consumer to high financial risk, the more likely it is that the insurance company will require a questionnaire. Many questionnaires are structured so they can be scored in the field by the producer. The questionnaires involve numerical scoring that determines if the consumer’s risk tolerance is within the suitable ranges for the specific product being recommended. When more than one consumer is purchasing the annuity (i.e. a husband and a wife), the risk tolerance of both parties to the annuity should be calculated.

A consumer’s risk tolerance will change based on age, income requirements, financial goals, and other considerations. For example, a 67 year-old retiree generally has a lower risk tolerance than a 35 year-old working professional because the younger individual will likely have a much longer period of time to compensate for any financial losses or setbacks. An individual with $10,000 in an investment fund will generally have a lower risk tolerance than an individual with $100,000 in his fund because the individual with the smaller fund has less money to rely upon for future needs.

It can’t be emphasized enough that a client’s risk tolerance will often change as time passes. Proper planning and the suitability evaluation should take into consideration the possibility of future emergencies and unforeseen events.

**NEED FOR FULL CONTACT DISCLOSURE**

California Insurance Code (CIC) requires that any annuity contract that does not provide cash surrender benefits, or does not provide death benefits at least equal to the minimum non-forfeiture amount prior to the beginning of the annuitization period, include a statement in a prominent place in the contract that such benefits are not provided.

Why is this requirement important enough to be included in insurance code and what are the implications of the requirement? As producers, we are aware of the technical aspects
of insurance and annuity products—the average consumer is not. Many consumers simply assume that if they purchase an annuity and choose to cancel it, they will receive all their money back, plus interest. Even though we perform a suitability evaluation before the purchase by asking the consumer numerous questions about his goals, objectives and needs, and even though we complete a risk tolerance questionnaire before the purchase to determine the consumer’s investment philosophy, the consumer doesn’t always understand precisely what we mean or how his decision will affect him at some undetermined point in the future.

Revealing to the consumer that the purchase of an annuity is designed to be a long-term venture, and should not address short-term goals, is essential. Failure of the producer to disclose these facts is both unethical and illegal. Failure on the part of the consumer to understand these facts may lead to undesirable taxable events and the loss of principal. The following information concerning annuity contract benefits and features is typically contained in an annuity disclosure form and should be reviewed with the applicant, along with an offering by the producer to the consumer of pertinent examples and consequences for each element in the contract:

- The guaranteed, non-guaranteed, and determinable elements of the contract—along with their limitations and how those limitations operate
- The initial crediting interest rate of the annuity, including any bonus or introductory interest rates, the duration of such rates, and the fact that interest rates may change in the future and are not guaranteed
- Guaranteed and non-guaranteed periodic options
- Value reductions caused by withdrawals from, or surrender of, the annuity
- How contract values may be accessed by the consumer
- Any available death benefits and the method of their calculation
- A summary of the federal tax status pertinent to the contract and any applicable tax penalties for withdrawal from the contract
- Impact of any rider, specifically a long-term care rider

**Need for Complete Record Keeping**

The protection of the consumer is the first and foremost concern of the California Department of Insurance in this regard. Maintaining records for annuity transactions between any administrators, insurance companies, and insured persons during the term of the annuity, and for five years after the last transaction, serves to illustrate to all parties that compliance with legal obligations has taken place. Keeping records that document all suitability evaluations, disclosures, and other requirements of code serve to protect the consumer and all other parties to an annuity contract, including the producer.

Monies collected in all annuity transactions must be held in a fiduciary capacity. Funds should be distributed only to parties entitled to receive them and accurate records of receipt, deposit into bank accounts, and withdrawal from bank accounts should be maintained in scrupulous detail. All records should be kept for at least five years after each transaction and for five years after the termination of any administrator agreement. The NAIC Suitability Model calls for maintenance of records in paper, photographic,
microprocess, magnetic, mechanical or electronic media, or by any process that accurately reproduces the actual document.

In addition to the routine record maintenance requirements of fixed and indexed annuities, FINRA and the SEC have a list of requirements for variable annuities, specifically documentation that the consumer was provided a prospectus. Producers selling variable annuities should be familiar with FINRA’s compliance requirements in addition to those of CIC.

The following types of information should be maintained in books and records:

- Applications
- Policy change forms and requests
- Policy riders and endorsements
- Disclosure forms
- Risk tolerance and other worksheets
- Premium invoicing and payments
- Withdrawal and surrender charges and fees
- Claim forms and documents
- Claim payments
- Bank account information of all accounts and the purposes of their use
- Bank account deposits and withdrawals
- Any fees charged by the administrator
- Insurance company data, including financial stability

The producer should exert the utmost due diligence in securing all required information from the consumer before and during the sale of an annuity, and in all transactions effected after the sale. Appropriate disclosure forms, checklists, worksheets, and buyer’s guides should be obtained, disseminated, and documented. All premium payments, withdrawals, and surrenders should be recorded in detail, especially in light of the myriad of tax consequences that may be involved. Depending upon requirements of the state of California, the insurance company, FINRA, the SEC, and other regulatory authorities, copies of all records should be maintained in the formats prescribed for the appropriate time frames.

Because of the rising number of suitability complaints against producers, proper documentation and record keeping often makes the difference between proving or disproving the producer’s efforts at due diligence and compliance with the Suitability Model when a complaint is filed. Not only do proper record keeping practices keep a producer compliant with California Insurance Code, they build consumer trust and improve relations with the insurance companies a producer represents. James Brady, a leading financial and audit professional, credits high levels of corporate responsibility and ethical standards pertaining to record keeping as one component of the success level experienced by professionals in the financial services industry.

If a producer maintains copies of all applications, rider and endorsement requests,
contract change requests, disclosure forms, risk tolerance questionnaires, financial status worksheets, premium payments, account review documents, etc. she can establish her level of professionalism, ethical standards, and credibility if a complaint is filed against her. In doing so, she is also protecting the interests of her client and maintaining clear evidence of her recommendations and the information and data upon which they were based.

**DISCLAIMER – REFER TO ATTACHMENT II**

Attachment II, which appear at the end of this material, describes in detail the requirements of Section 101687.7 of the California Insurance Code with respect to full contract disclosure.

**POLICY CANCELLATIONS AND REFUNDS**

In addition to our previous discussions about the Free Look period policy replacements, cancellations, and refunds, it is important to note that specific requirements apply to policy cancellation, changes, and replacements involving seniors who are aged 60 or older—although the definition of a senior, or “elder,” in code refers to individuals age 65 and older.
CHAPTER 9 – REVIEW QUESTIONS

Answers are in the back of the text

1. If replacement is, or may be, involved in the sale of an annuity, the producer must supply the insurance company with _____.
   [a] A copy of the replacement notice required by CIC
   [b] A copy of the replaced policy
   [c] A copy of his producer license
   [d] A copy of the applicant’s driver’s license

2. A Free Look period of _____ days is required when replacement of an annuity is involved.
   [a] 10
   [b] 20
   [c] 30
   [d] 45

3. When advertising, _____ must be included on every business card, piece of stationery, advertisement, or illustration.
   [a] The producer’s name
   [b] The producer’s license number
   [c] The producer’s social security number
   [d] The producer’s title

4. All of the following must be kept as part of the record keeping process, EXCEPT _____.
   [a] Disclosure forms
   [b] Occupation details of the applicant
   [c] Risk tolerance and other worksheets
   [d] A voided check belonging to the applicant
Chapter 10

The Senior Market

RISK AND THE SENIOR CLIENT

Because of a number of factors, the senior segment of the population in this country is at more risk, in a variety of ways, than any other segment. Seniors are more susceptible to high-pressure sales tactics and scams, especially those that prey on a senior’s fears associated with longevity and the condition of their health. Because medical science is advancing at such a rapid rate, people are living longer, which presents the very real possibility that many seniors will outlive the retirement income they’ve set aside—if they don’t spend it all on medical and health care costs.

Everyone assumes some risk when purchasing an annuity; seniors assume a much higher risk. Ethical producers take pains to explain all available options, and elicit as much information as possible, when dealing with senior clients in order to appropriately gauge the level of risk they can safely assume.

PRE AND POST-RETIREMENT PLANNING

Choosing and executing a successful retirement plan doesn’t happen overnight. An individual’s retirement goals should begin to take shape at around age forty—and sometimes at a younger age. Considerations when setting retirement goals in the earliest phase of retirement planning include:

- What is the desired retirement age?
- Will a spouse or other individual be a party to the retirement plan?
- What is the desired retirement lifestyle?
- Where will the funding for retirement come from?
- What retirement funding options are available?
- How will assets be allocated both before and after retirement?
- What are the tax advantages available throughout the process AND in retirement?
- What financial, legal, and insurance professionals will assist with the process?

As the individual approaches retirement, he should not only continue to focus on his goals but also to revise them. A job change, children moving out of the home, acquisition of property, divorce, and other life-altering events often dramatically affect a person’s retirement goals and the ability to carry them out. Existing investments, pension and profit-sharing plans, inheritances, and taxes all manage to influence the process, as well.

Once a consumer has officially retired, he should carry on with his plans and revisions,
with an eye to his very special needs now that he is no longer earning income and must support himself with the retirement funds he has established. Did he accurately predict his retirement expenses and cost of living? Is he living the lifestyle he intended five (or twenty) years ago? Do his spouse and/or other family members depend upon the retirement income he’s provided for himself? Will required minimum distributions come into play at age 70 ½ and, if so, how will they affect the plan?

An insurance producer must be familiar with all phases of retirement planning, and all the concerns a client might have, in order to properly advise and recommend products, features, benefits, and available options—especially when dealing with seniors, who have much less time to act than other consumers do.

FINANCIAL CONCERNS

Once a person reaches the age of 60 or 65, he has far more concerns than younger people realize. Perhaps he doesn’t have to get up and head to the office each morning, but the worry about bringing home the bacon doesn’t disappear just because he no longer sits behind a desk from 9 to 5. Sure, he can hop in the RV and tour the mid-west in the summer, or spend every morning at the fishing hole, but these pursuits cost money—and he’s no longer earning any.

SOCIAL SECURITY

The majority of people depend upon their Social Security benefits in retirement, however, most don’t understand when benefits start or the most beneficial way to take advantage of them. For example, every consumer knows he can opt to begin receiving Social Security retirement benefits at age 62, but few realize they’ll receive a permanent reduction in their monthly benefit in an amount between 25% and 30%! Poor planning may result in taking a huge bite out of someone’s retirement income.

If an individual begins working after receiving Social Security benefits, his benefit amount may change and he may actually have some of his benefits withheld if he has excess earnings. Once the individual reaches full retirement age, the SSA will recalculate the benefit amount to give the individual credit for any months in which he didn’t receive benefits because of earnings.

Here is a chart that shows the age at which a person receives full Social Security retirement benefits:

<table>
<thead>
<tr>
<th>Year of Birth</th>
<th>Full Retirement Age</th>
<th>Year of Birth</th>
<th>Full Retirement Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937 or earlier</td>
<td>65</td>
<td>1955</td>
<td>66 and 2 months</td>
</tr>
<tr>
<td>1938</td>
<td>65 and 2 months</td>
<td>1956</td>
<td>66 and 4 months</td>
</tr>
<tr>
<td>1939</td>
<td>65 and 4 months</td>
<td>1957</td>
<td>66 and 6 months</td>
</tr>
<tr>
<td>1940</td>
<td>65 and 6 months</td>
<td>1958</td>
<td>66 and 8 months</td>
</tr>
<tr>
<td>1941</td>
<td>65 and 8 months</td>
<td>1950</td>
<td>66 and 10 months</td>
</tr>
<tr>
<td>1942</td>
<td>65 and 10 months</td>
<td>1960 and later</td>
<td>67</td>
</tr>
<tr>
<td>1943-1954</td>
<td>66</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
If a person delays receiving Social Security benefits past his full retirement age, his benefits will be increased by a certain percentage, depending upon his date of birth. The benefit increase no longer applies when a person reaches age 70, even if he continues to delay taking benefits.

Here is a chart that shows the increase percentages for delayed retirement:

<table>
<thead>
<tr>
<th>Year of Birth</th>
<th>Yearly Increase</th>
<th>Monthly Rate of Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1933-1934</td>
<td>5.5%</td>
<td>11/24 of 1%</td>
</tr>
<tr>
<td>1935-1936</td>
<td>6%</td>
<td>½ of 1%</td>
</tr>
<tr>
<td>1937-1938</td>
<td>6.5%</td>
<td>13/24 of 1%</td>
</tr>
<tr>
<td>1939-1940</td>
<td>7%</td>
<td>7/12 of 1%</td>
</tr>
<tr>
<td>1941-1942</td>
<td>7.5%</td>
<td>5/8 of 1%</td>
</tr>
<tr>
<td>1943 and later</td>
<td>8%</td>
<td>2/3 of 1%</td>
</tr>
</tbody>
</table>

NOTE: If a person delays retirement, he should still sign up for Medicare at age 65. Delaying this process may generate higher costs or affect eligibility.

Having benefits reduced by receiving them a few years early doesn’t seem like a significant thing to some people; neither does forfeiting an increase in benefits by not working a year longer than planned. But most people reconsider their position after looking at actual figures. Let’s consider two scenarios:

Scenario #1: Eleanor opts to begin receiving her Social Security retirement benefits at age 62 instead of at age 66 (she was born in 1947). If her monthly benefit would have been $1,000 at her full retirement age of 66, her benefit reduction is about 30%. This translates into a monthly benefit of $700 instead of $1,000. Beginning now, when she starts to receive benefits, she’ll receive $3,600 less per year. If Eleanor lives to be 82 years old, she’ll have forfeited $72,000 in Social Security retirement income.

Scenario #2: Eleanor opts to work one extra year past her full retirement age to take advantage of the increased benefit percentage. If her monthly benefit would have been $1,000 at age 66, she’ll receive an additional 8% per year if she begins receiving benefits at age 67. This means she’ll receive $1,080 per month; or $960 more per year. If Eleanor lives to be 82 years old, she’ll have earned an extra $14,400 in Social Security retirement income.

RETIREMENT PLAN DISTRIBUTIONS

Many retirement plans, including qualified IRAs and 401(k)s require an individual to begin minimum distributions no later than April 1\textsuperscript{st} of the year following the year in which they turn age 70 ½. The amount of the distribution is calculated based on life expectancy—the number of years over which it is expected withdrawals will be made. (The IRS provides three life expectancy tables: the Joint and Last Survivor Table, the Uniform Life Table, and the Single Life Expectancy Table.) These distributions are subject to taxation as ordinary income for the qualified portion of the assets and the account’s earnings; the portion of distributions that are a return of pre-taxed principal are not subject to income tax. If an individual fails to withdraw the required minimum distributions in a tax year, a penalty will be assessed that equals 50% of the amount of the
required withdrawals.

**INVESTING RETIREMENT ASSETS**

Once a person has retired, his primary goal is keeping what he has. Yes, investing and growing assets is an attractive prospect, but most seniors don’t want to—and shouldn’t—risk their current assets and the safety of their principal for the possibility of accumulating more funds. Having said that, there are circumstances where seniors have enough liquidity to take some risk. It is up to the producer to help a senior determine precisely where he is with respect to liquidity and the potential for assuming risk and, then, to act accordingly.

**SURRENDER CHARGES**

In addition to any surrender charges contained in a particular annuity contract, it is very important for a producer to remind his client that premature surrender of, or withdrawal from, an annuity—and other retirement plans such as IRAs and 401(k)s—prior to age 59 ½ will generate a 10% federal penalty.

Even more important, is the aspect of surrender charges when a senior is considering the replacement of an existing annuity. While the replacement contract might be attractive, it will likely involve a surrender term and penalties. It is possible to add benefits to the contract, such as critical illness and other crisis waivers to eliminate some penalties, but these options cost money—which reduces the beneficial effect of the replacement. The producer needs to keep the *substantial financial benefit* doctrine mind in all times when replacing an annuity contract.

**INSURANCE CONCERNS**

In the senior market, insurance concerns have a much more far-reaching effect than they did when the consumer was younger. Premiums are much higher for seniors if they’re purchasing brand new policies and, if they suffer from health issues, they may not be able to purchase new insurance coverage at all.

Many people are fortunate to have medical, disability, and life insurance included in their employee benefits. What happens when they retire? Do their benefits continue?

If the medical, disability, and life insurance benefits do not continue after the senior retires, the producer is often charged with the duty of helping the senior find alternative coverage. An individual is eligible for Medicare at age 65, but will that coverage be adequate for the senior’s needs? Can the senior afford a Medicare Supplement policy? The senior probably won’t need to continue his disability coverage, but what should he do if he decides to work part-time after retiring? Will he still need the life insurance? And what if he decides to retire *before* turning age 65?

Planning for long-term care should begin well before a person becomes a senior but, unfortunately, many people don’t consider long-term care coverage until after they
develop a medical issue. They can’t purchase coverage, for the most part, once they’ve developed a serious medical condition and they think California’s Medi-Cal program will pay their expenses. In most cases, they think wrong!

Medi-Cal is the state version of Medicaid: it’s a program that allows for certain people to obtain required medical care they can’t afford. It is available only to individuals and families who meet the criteria of eligibility that is determined by federal and state law. The Medi-Cal website says: “This is a public health insurance program which provides needed health care services for low-income individuals including families with children, seniors, persons with disabilities, foster care, pregnant women, and low income people with specific diseases such as tuberculosis, breast cancer, or HIV/AIDS. Medi-Cal is financed equally by the State and federal government.”

The California Partnership for Long-term Care is dedicated to educating Californians on the need to plan ahead for their future long-term care and to consider private insurance as a vehicle to fund that care. The California Partnership for Long-Term Care is an innovative program of the State of California and the Department of Health Care Services in cooperation with a select number of private insurance companies. These insurance companies have agreed to offer high quality policies that must meet stringent requirements set by the Partnership and the State of California. These special policies are commonly called "Partnership policies." Partnership policies take the guesswork out of ensuring that the consumer purchased a quality policy. In addition to many other consumer protection features, Partnership policies offer the special benefit of Medi-Cal Asset Protection.

**ESTATE PLANNING**

Regardless of the size of a consumer’s estate, the importance of having an estate plan in place cannot be overstated. An estate plan is comprised of several essentials: a will, a power of attorney, and a living will (or health care proxy or medical power of attorney). Sometimes a trust forms part of an estate plan.

When beginning an estate plan, it is important to consider all assets and what role they will play in the plan. Who is listed as beneficiary on the life insurance policies, retirement and pension plans, IRAs, etc.? Who will inherit the assets when the owner dies, including homes, businesses, and real estate? Who will be authorized to make medical decisions if the estate owner is unable to do so?

Once a person (or couple) answers these questions, the easiest way to assure that his (or their) wishes are carried out is to state these wishes in a will. Dying without a will, and allowing the state to determine how to distribute assets, can be costly for a person’s heirs and may ultimately result in the implementation of estate settlement contrary to what an individual actually desired.

The federal estate tax exemption is $3,500,000 in 2009. In 2010, it is scheduled to phase out. Unfortunately, unless Congress passes new laws, it will be reinstated in 2011—at a
A person may leave an unlimited amount of assets to a surviving spouse without the spouse incurring a taxable event but, when the spouse dies, his/her taxable estate will be significantly increased, thereby generating a huge tax bite for children (or the spouse’s heirs).

Life insurance and annuities may be effective tools in the estate planning process, especially when a client dies. Death benefits can cover costs that range from final expenses to the payment of taxes, thus allowing a surviving spouse or the client’s heirs from having to liquidate assets.

SELLING TO THE SENIOR MARKET

When today’s seniors bought their first insurance policies, Whole Life insurance was popular—Universal Life hadn’t even been invented! The idea of flexible premium payments, cash value accounts with varying rates of interest, and buying an insurance policy that could invest in the stock market were unheard of. Insurance products have grown more complicated over the years and annuities are exceedingly complicated.

Many seniors are not equipped to understand all the changes that have been implemented in the tax treatment of insurance products or with the new features and benefits available. For this reason, it is especially important for a producer to be explicit in his explanation of contract provisions. Illustrating to the senior consumer all the consequences of a purchase, both positive and negative, and then documenting them for the client’s review is the best way to help a senior make the best buying decision.

BUYER COMPETENCE

The issue of legal capacity often arises in cases involving senior consumers. Legal capacity is the term used to define a person who is able to understand and appreciate the consequences of his actions. It determines his “buyer competence.”

A person who lacks legal capacity cannot, for example, enter into a contract, give a power of attorney, make a will, consent to medical treatment, or transfer property. Minors typically lack legal capacity, as do individuals who are mentally handicapped or under the influence of alcohol. The older we become, the more likely we are to develop a mental disease or disability such as Alzheimer’s disease or dementia, which diminishes both our legal and mental capacity.

If a producer sells an annuity to an individual who lacks legal or mental capacity, it could be argued that the sale is inappropriate—even if neither the producer nor the consumer were aware of the lack of capacity. Since basic contract law requires “competent parties” for a contract to be considered legal, it could further be argued that the contract is not valid and binding upon the incompetent individual.

Some seniors experience diminished capacity as they age; recognizing the signs of such a condition is often difficult, especially for a producer who doesn’t routinely have dealings
with seniors. Producers who exert undue influence over seniors commit elder abuse. According to the National Committee for the Prevention of Elder Abuse, “undue influence,” is defined, in part, as: “…an individual who is stronger or more powerful making a weaker individual to do something that the weaker person would not have done otherwise. The stronger person uses various techniques or manipulations over time to gain power and compliance.” Such techniques are both illegal and unethical.

The SEC recently reported that diminished mental capacity affects approximately 20 percent of seniors aged 85 and older. It is important that producers recognize the indicators a prospective insured may exhibit that illustrate the lack of short term memory, or judgment, that is required to knowingly purchase an annuity.

Diminished mental capacity does not mean an individual does not have legal capacity; it does indicate, however, that the individual does not function as well as s/he has functioned in the past. Since each person is unique and possesses varying degrees of decision-making capabilities at various stages in his life, it is a considerable challenge for a producer to recognize diminished mental capacity in a person he just met.

For a producer who is not formally trained in a mental health disciplines (and most are not), assessing diminished capacity is possible in some cases but, in general, beyond the expertise of a typical producer. A major issue involved in assessing diminished capacity pertains to short term memory. Many individuals have occasional memory problems due to the natural aging process and take longer to make decisions. Loss of memory and/or the onset of diminished mental capacity is usually a gradual process that accelerates over time. It is entirely possible for a senior consumer to make an insurance-related decision today, when appearing cognitively adept, and to be considered cognitively impaired two or three years in the future—after a complaint of elder abuse has been filed.

Below is a list of several indicators of diminished mental capacity of which producers should be aware. Not all of these indicators will be apparent in the context of a typical meeting with a senior. Additionally, some of these indicators require prior knowledge of the senior in order to determine if deterioration has taken place in a particular aspect of the senior’s behavior over time.

- **Memory loss:** The senior is repeating questions, forgetting details, forgetting appointments, misplacing items or losing track of time
- **Disorientation:** The senior is confused about time, place, or simple concepts OR the senior appears to be disoriented with surroundings or social settings
- **Difficulty performing simple tasks:** The senior lacks the ability to remember the order of performance of the steps necessary to complete a simple task such as tying one’s shoes.
- **Difficulty speaking:** The senior use words that do not fit the context of their use
- **Difficulty understanding consequences:** The senior appears unable to appreciate the consequences of decisions.
- **Difficulty with decision-making:** The senior makes decisions that are inconsistent with his or her current long-term goals or commitments.
- **Attitude:** The senior seems overly optimistic.
• **Difficulty following simple directions:** The senior has difficulty with directions, particularly when they include multiple steps that must be performed in sequence.

• **Deterioration of handwriting and signature:** The senior appears unable to accurately write the letters of the alphabet or the letters are written backwards.

• **Drastic mood swings:** The senior may exhibit a swift change in mood within a short period of time with no obvious reason for the mood change.

• **Difficulty with finances:** The senior does not remember or understand recently completed financial transactions.

• **Lack of attention to personal hygiene:** The senior appears uncharacteristically unkempt.

• **Confusion as to date and time:** The senior may be confused as to the season, the current month, the day of the week, or the time of the day.

The Alzheimer’s Association publishes a list of explanations for some of the indications of Alzheimer’s Disease. While this information relates to the recognition of Alzheimer’s, it also provides a brief description of normal behaviors that can be of value to a producer when attempting to recognize signs of short term memory loss and/or lack of judgment in senior consumers:

• **Memory loss that affects job skills.** It is normal for a person to occasionally forget an item at the grocery store, a deadline, or a colleague's name; frequent forgetfulness or unexplained confusion may signal that something is wrong.

• **Difficulty performing familiar tasks.** Busy people get distracted from time to time. For example, a person might leave something on the stove too long or forget to serve the vegetables at dinner. People with Alzheimer's disease might prepare a meal and not only forget to serve it but also forget they made it.

• **Problems with language.** Everyone has trouble finding the right word on occasion; a person with Alzheimer's disease may forget simple words or substitute inappropriate words, making his or her sentences difficult to understand.

• **Disorientation about time and place.** It's normal to momentarily forget the day of the week or what you need from the store. People with Alzheimer's disease can become lost on their own street--not knowing where they are, how they got there, or how to get back home.

• **Poor or decreased judgment.** Choosing not to bring a sweater or coat along on a chilly night is a common occurrence. A person with Alzheimer's, however, may dress inappropriately in more noticeable ways, such as wearing a bathrobe to the store or wearing several blouses on a hot day.

• **Problems with abstract thinking.** Balancing a checkbook can be challenging for many people, but for someone with Alzheimer's disease, recognizing numbers or performing basic calculation may be impossible.

• **Misplacing things.** Everyone temporarily misplaces a wallet or keys. A person with Alzheimer's disease may put these and other items in inappropriate places, such as an iron in the freezer or a wristwatch in the sugar bowl, and then not recall how the item got there.

• **Changes in mood or behavior.** Everyone experiences a broad range of emotions, such behavior is part of being human. People with Alzheimer's disease tend to exhibit more rapid mood swings for no apparent reason.
• **Changes in personality.** People's personalities may change somewhat as they age. But the personality of a person with Alzheimer's can change dramatically, either suddenly or over a period of time. It is not uncommon for a person suffering from Alzheimer’s to have his normally easygoing temperament become angry, suspicious, or fearful.

• **Loss of initiative.** It's normal to tire of housework, business activities, or social obligations, but most people either retain or regain their interest. The person with Alzheimer's disease may remain uninterested and uninvolved in many or all of his usual pursuits.

One method of preventing the future claim of an ethics or suitability violation involving a senior is for a producer to invite a trusted family member or other individual to be present when meeting with a senior for the purpose of discussing insurance or annuities. Privacy issues may have an impact on this practice and producers should make certain compliance with all privacy laws and regulations are in place. Another concern for the producer is the possibility that the trusted family member is, himself, the perpetrator of elder abuse.

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**Examples of a family member exploiting a position of influence over a senior to gain access to the senior’s assets, funds, or property (the definition of elder abuse) include:**

- Cashing a senior’s checks without authorization or permission
- Forging a senior’s signature
- Misusing or stealing a senior’s money or possessions
- Coercing or deceiving a senior into signing a document, such as a will or a contract
- Improper use of conservatorship, guardianship, or power of attorney

**Possible signs of elder abuse being committed by a family member include:**

- The senior’s sudden reluctance to discuss financial matters
- Sudden, unusual, or unexplained withdrawals from, or other changes in, a senior’s bank accounts, insurance policies, or other investments
- Abrupt changes in a senior’s will, trust, or power of attorney
- The senior’s increasing lack of contact with, and interest in, the outside world
- Admission or suggestion that a financial or material exploitation is taking place
- The senior’s concern or confusion about missing funds in his/her account
- Fear of placement in a nursing home if money is not given to a caretaker
- Appearance of insufficient care or neglect, despite having money and a means of support

California Civil Code addresses the issue of legal capacity in Sections 38 and 39:

- **Section 38:** “A person entirely without understanding has no power to make a contract of any kind, but the person is liable for the reasonable value of things furnished to the person necessary for the support of the person or the person’s family.”
- **Section 39:** “(a) A conveyance or other contract of a person of unsound mind, but not entirely without understanding, made before the incapacity of the person has
been judicially determined, is subject to rescission; (b) A rebuttable presumption affecting the burden of proof that a person is of unsound mind shall exist for purposes of this section if the person is substantially unable to manage his or her own financial resources or resist fraud or undue influence. Substantial inability may not be proved solely by isolated incidents of negligence or improvidence.”

Because CIC expressly addresses the issue of a person being unable to manage his own financial resources or to resist undue influence, proving that a senior suffered from a lack of legal capacity is not a difficult task. The Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC), and the State of California are increasingly concerned about elder abuse and unethical sales practices targeting seniors. An ethical producer will report all instances of suspected senior abuse to the appropriate authorities and will also refrain from working with a senior if the producer even suspects the senior is a victim of diminished legal or mental capacity.

UNIQUE ETHICAL AND COMPLIANCE ISSUES

Our legal obligations are defined and judged by law. Whether or not an individual is aware of a particular law, it exists—in black and white: law books document a law’s existence, online versions of legal code are easily available to anyone with access to a computer, and entities such as law enforcement and the judicial system are exceedingly familiar with legal code. The consequences of violating a legal obligation (breaking a law) also appear in black and white. Sometimes they vary—depending upon the decisions made by judges, juries, and others with the power to mete out justice—but a generalized view of consequences is readily apparent to most people in our society.

For example, a sign on a highway states: 55. Drivers [should] know the sign is posted to display the legal speed limit. In other words, the jurisdiction has a law stating it is unlawful to drive in excess of 55 miles per hour on that highway. If a law enforcement officer witnesses an individual driving in excess of 55 miles per hour, the officer is entitled to issue the driver a moving violation for speeding. The recipient of the moving violation must pay a fine—unless he takes issue with the citation and appeals its issuance.

Cut and dried, right? Since drivers know it’s illegal to drive faster than 55 miles per hour on that highway, no one does. Right? Wrong. The majority of people driving that highway travel at speeds in excess of 55 miles per hour. One person puts the car on cruise control at 59 miles per hour because he knows law enforcement doesn’t stop drivers until they’re driving at least five miles an hour over the speed limit. Another person drives at speeds up to 65 miles per hour because he knows that even if he does get a citation for speeding, tickets for traveling between one and ten miles per hour over the speed limit are held locally and not reported to the state for purposes of appearing on his driving record. Each of these people feels justified in breaking the law because each has made a personal determination that the speed limit is too low. Neither person feels he is breaking the law although, technically, each is and—when pressed, will admit it.

Unlike legal obligations, ethical obligations aren’t always defined and seldom appear in
black and white. They are a consensus, by society, of what is acceptable conduct. One person’s set of moral values is considered Puritan to another person. One group’s assessment of what constitutes acceptable principles of conduct sets another group gasping in disgust.

For example, let’s say Jane is walking on a busy city sidewalk. The fellow in front of her pulls something from his pocket and a wad of cash falls onto the sidewalk and bills scatter at her feet. The teenager walking beside Jane snatches handfuls of bills off the ground and stuffs them into her purse. Jane gathers the remaining bills and races after the man who dropped the money, calling after him.

Not so cut and dried, is it? Maybe the teenager didn’t see the money fall from the man’s pocket. Maybe she did. Either way, she obviously felt entitled to the money. Jane, on the other hand, did not. This illustration paints a vivid picture of different ethical values.

Why do the teenager and Jane have different ethical values? Because of a number of factors, including differing perceptions of good versus bad and right versus wrong. They also experience dissimilar levels of self-interest, awareness of consequences and results, and concepts of what is moral. Perhaps Jane was raised in a loving family by parents who regularly attended religious services; perhaps the teenager was raised with seven other siblings by a mother on public assistance. Or, maybe the teenager’s house was recently burgled and she’s still upset when she thinks about the $500 cash that was stolen. Regardless of our speculation about the reasons for Jane and the teenager behaving differently, neither the teenager nor Jane seemed to experience an ethical dilemma when faced with all that cash at her feet. Each plunged into action without dithering. A third person might have had a terrible time deciding what to do.

Maybe he would have wanted to keep the cash because he’s behind on his rent but would have felt guilty because he saw it fall out of the other fellow’s pocket. He could justify keeping the cash if he simply found it on the sidewalk but, keeping it when he knew the person to whom it belonged just isn’t something he could live with. This third person’s dilemma is a direct result of his personal opinion of what is right, his level of social responsibility, and his degree of self-interest.

Now, let’s take this understanding into the world of insurance and, specifically, annuities. The insurance industry accepts the following phrases as being right—or ethical:

- Doing what’s right for the client
- Looking out for the client’s best interests
- Putting the client’s best interests first
- Do no harm
- Always leave the client in a better position than he was in before you did business with him

Some insurance professionals, however, choose to believe that the following phrases are right—or ethical:

- If no one knows, it’s okay
• If I don’t get caught, it’s okay
• Who will it hurt?
• Everyone does it

Two sincere, informed, professional insurance producers can legitimately have different views about whether a particular transaction is right or wrong. While these same two individuals might agree that they should do “right” by the client, they may vigorously disagree about what is “right.”

Many ethical considerations surround the sale of an annuity contract. *Ethics* is hard to define in practice and equally hard to enforce because it requires an agreement about what is right and fair and in the client’s best interests. While the facts of some situations may be viewed and considered by most to be unethical, the real test of defining or enforcing ethics comes in the more grey areas. Ethics also requires a commitment to a set of values and principles that, by nature, are vague. Ethics requires each of us to read or hear these principles, interpret them, and incorporate what we think they mean into our daily business practices.

The easiest way to determine if something is in the client’s best interests is to ask him. Yes, come right out and ask, *Does that work for you? Does it make good sense? Will it help you or will it make things worse for you?* Another way to determine if something is in the client’s best interest is to encourage him to talk with his accountant, attorney, or a family member. If issues are brought up by these individuals, they need to be addressed—what better way to address them than with the client’s full cooperation and with the assistance of another trusted advisor or family member?
CHAPTER 10 – REVIEW QUESTIONS

Answers are in the back of the text

1. All of the following are considerations when setting retirement goals in the earliest phase of retirement planning EXCEPT _____.
   [a] What retirement fund options are available?
   [b] How will assets be allocated both before and after retirement?
   [c] Were retirement costs and standard of living predicted accurately?
   [d] What is the desired retirement age?

2. An individual can opt to begin receiving Social Security retirement benefits at age _____.
   [a] 60
   [b] 62
   [c] 65
   [d] 70

3. All of the following are examples of elder abuse EXCEPT _____.
   [a] Misusing or stealing a senior’s money or possessions
   [b] Cashing a senior’s checks with permission
   [c] Improper use of conservatorship, guardianship, or power of attorney
   [d] Forging a senior’s signature
Chapter 11

Role of the California Life and Health Insurance Guarantee Association With Respect to Annuities

The California Life & Health Insurance Guarantee Association (guarantee association) is a statutory entity created in 1991 when the California legislature enacted the California Life and Health Insurance Guarantee Association Act. The guarantee association is composed of all insurance companies licensed to sell life insurance, health insurance, and annuities in the state of California. Each member life and health insurance company is assessed fees that are collected and which provide the funds necessary for the guarantee association to offer protection.

In the event a member insurance company is found to be insolvent and is ordered to be liquidated by a court, the Guarantee Association Act enables the guarantee association to provide protection (up to the limits spelled out in the Act) to California residents who are life and health insurance policyholders, and annuity contract holders, with the insolvent insurer.

Specifically, when a member insurance company is found to be insolvent and is ordered liquidated, a special deputy receiver takes over the insurer under court supervision and processes the assets and liabilities through liquidation. The task of servicing the insurance company's policies and providing coverage to California's resident policyholders becomes the responsibility of the guarantee association. The protection provided by the guarantee association is based on California law and the language of the insolvent company's policies at the time of insolvency.

Protection by the guarantee association may be provided in a variety of ways. For example, the guarantee association may provide coverage directly to the policy holder. Another example of coverage would be for a financially sound insurance company to take over the insolvent company's assets and insurance and annuity policies, and assume responsibility for continuing coverage and paying covered claims. In some situations, the guarantee association may work with other state guarantee associations to develop an overall plan to provide protection for the insolvent insurer's policyholders. The amount of protection provided, and when it is received, depends upon the particular arrangement for handling the insolvent insurance company's obligations.

The following types of policies and plans are NOT protected by the guarantee association:

- Insurance companies not licensed to do business in California
Policies issued by medical, dental, or health care service corporations
Managed care plans
Self-insured employer plans
Fraternal benefit society insurance certificates
Non-guaranteed elements of a policy; such as the non-guaranteed portions of a variable annuity or life insurance policy that must be sold with a prospectus
Guaranteed interest rates that exceed those set by the guarantee association
Most unallocated annuity contracts
Charitable gift annuities

The amount of protection provided is 80% of the contract value with a maximum of $100,000. The maximum amount protected by the guarantee association for all annuities purchased from a single insurance company is $100,000. For example, if Harvey purchased three $50,000 annuities from Company A, only $100,000 of his annuity values are protected by the guarantee association. (IRAs are protected up to the same limits as an annuity.)

If Harvey and his wife each own a $100,000 annuity, each would receive protection of $80,000 (80%), for a total of $160,000 of protection on the total $200,000 of annuity values.

If a policyholder receives benefits from the guarantee association, he is considered to have assigned his rights under the covered policies to the guarantee association—to the extent of benefits received from the guarantee association. This right is similar to the insurance company’s subrogation rights in a property and casualty insurance policy. The guarantee association may require a written assignment of such rights prior to paying any benefits. The law states that the guarantee association is a creditor of the insolvent insurance company to the extent of assets attributable to covered policies. The guarantee association receives the rights of recovery and other equitable and legal remedies available to the policyholder.

If a participating insurance company becomes insolvent, official notice of such insolvency will be sent to each policyholder by the Division of Insurance in the state of the insurance company’s state of domicile. For example, if Company A is licensed to do business in the State of California and its Home Office is in the State of New York, New York is the insurance company’s state of domicile and the official notice will be sent by New York’s Division of Insurance.

Benefits are paid as promptly as possible once a claim is submitted, however, due to the legal constraints of insolvency, delays often occur and may postpone payment of benefits for several months. It does not matter where payees or beneficiaries live, however, the policyholder must have been a resident of California at the time the insurance company became insolvent.
CHAPTER 11 – REVIEW QUESTIONS

Answers are in the back of the text

1. The guarantee association is composed of _____.
   [a] All insurance companies licensed to sell life insurance, health insurance, and
   annuities in the United States
   [b] All insurance companies licensed to sell life insurance, health insurance, and
   annuities in the state of California
   [c] All insurance companies not licensed to sell life insurance, health insurance,
   and annuities in the state of California
   [d] All insurance companies licensed to sell life insurance and annuities in the
   state of California

2. The maximum limit of protection, per policyholder, is _____.
   [a] 80% of the values in each annuity
   [b] 80% of the values in each annuity, subject to a maximum of $100,000 per
   annuity
   [c] 80% of the values in each annuity issued by the same insurance company
   [d] 80% of the values in each annuity, subject to a maximum of $100,000 for all
   annuities issued by the same insurance company
Attachments

The following pages contain California required attachments
ATTACHMENT I: PROVIDER LEGISLATIVE REFERENCE

Understanding of the following annuity legislation is significant. It provides the evolutionary changes for each law throughout the years. It is important to know what impact the following pieces of legislation have had on annuity insurance. To review or obtain copies of the following pieces of legislation, you may log onto the California Legislature’s Web site at http://www.leginfo.ca.gov or you may call the Legislative Bill Room at (916) 445-2645 to order copies of this legislation.

Year: 2003
SB 620, 2003, (Scott, Chapter 547), Annuities: life insurance: required disclosures and prohibited sales practices.
An act to amend Sections 787, 1725.5, 10127.10, and 10509.8 of, and to add Sections 789.9, 789.10, 1724, and 1749.8 to, the Insurance Code, relating to insurance.
• Enacts additional restrictions on advertising practices that target senior citizens and would expand the scope of existing restrictions, currently applicable to disability insurance, to life insurance and annuities.
• Prohibits the sale of annuities to seniors in certain circumstances.
• Prohibits insurance agents, brokers, and solicitors who are not attorneys from sharing commissions or other compensation with attorneys.
• Requires, effective January 1, 2005, specific training for life agents in order for these producers to sell annuities, unless the agents are nonresident agents who represent a direct response provider, as defined.
• Limits the investment of premiums during the 30-day cancellation period, except as specified, and revises the disclosure requirements applicable to the sale of life insurance and annuity products to seniors.
• Imposes restrictions on the sale of life insurance policies and annuities in the home of a senior citizen.
• Prohibits an agent or insurer from recommending the unnecessary replacement, as defined, of an annuity by a senior citizen.
• Imposes certain duties on the Insurance Commissioner in this regard, and enacts other related provisions.

SB 618, (Scott, Chapter 546), Insurance: unfair acts: licenses.
An act to amend Sections 782, 786, 789.3, and 10509.9 of, and to add Sections 1668.1 and 1738.5 to, the Insurance Code, relating to unfair acts.
• Raises the fine for a violation of these provisions to $1,500.
• Extends to individuals age 65 or older who purchase life insurance the protections described above that apply to those individuals who purchase disability policies.
• Declares that it applies to the purchase of life insurance only to the extent that it does not conflict with the provisions of law regarding cancellation of life insurance policies and annuities.
• Increases the amounts of these monetary penalties, as specified.
• Provides that, if the commissioner brings an action against a licensee under these provisions and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend the license pending the outcome of the action. It allows the commissioner to require the rescission of any contract marketed, offered, or issued in violation of these provisions.

• Authorizes the commissioner to suspend or revoke any permanent license issued if the licensee induces the client to make a loan or gift to or investment with the licensee, or to otherwise act in other specified ways that benefit the licensee or other people acquainted with or related to the licensee.

• Requires that, if a disciplinary hearing of this type involves allegations of misconduct directed against a person age 65 or over, the hearing be held within 90 days after the Department of Insurance receives the notice of defense, unless a continuance is granted.

• Sets forth the grounds for granting a continuance, and provides that the burden of proof in a hearing shall be by a preponderance of the evidence.

• Increases the amounts of these monetary penalties, as specified, and allows the commissioner to suspend or revoke the license of any person who violates these provisions.

AB 284 (Chavez, Chapter 381), Deferred annuities: nonforfeiture
An act to amend Sections 10168.1 and 10168.2 of, and to add Sections 10168.25 and 10168.92 to, the Insurance Code, relating to annuities.

• Requires that these annuity contracts also provide that the company shall grant the paid-up annuity benefit upon the written request of the contract owner.

• Eliminates the requirement applicable to certain contracts that a company reserve the right to defer the payment of the cash surrender benefit for a period of 6 months, and instead allows the company to reserve that right after making written request and receiving written approval of the commissioner, as specified.

• Allows payment of the cash surrender benefit to be deferred for a period not to exceed 6 months.

• Provides for a uniform method of calculating minimum nonforfeiture amounts under these contracts. It modifies the interest rate applicable to accumulations under these contracts, the amounts by which those accumulations may be decreased, and the minimum amount of considerations used to determine the minimum nonforfeiture amount, as specified.

• Provides that these provisions shall apply to contracts issued on and after January 1, 2006, but that a company may elect to apply them, on a contract-form-by-contractform basis, to any contract issued on or after January 1, 2004, and before January 1, 2006.

• Allows the Insurance Commissioner to adopt regulations to implement these provisions and to adjust the calculation of minimum nonforfeiture amounts for certain other contracts.
AB 2984 (Committee on Insurance, Chapter 203), Insurance: depository institutions: production agencies: surplus line brokers: reinsurance intermediaries.
An act to amend Sections 1628, 1637, 1639, 1656, 1662, 1679, 1704, 1750.5, 1765.2, 1767, 1768, 1781.3, and 10234.93 of, to add Sections 1638.5 and 1639.1 to, to add Article 5.2 (commencing with Section 759) to Chapter 1 of Part 2 of Division 1 of, and to repeal Sections 1647, 1648, 1649, 1659, and 1714 of, the Insurance Code, relating to insurance.

• Establishes provisions regulating retail sales practices, solicitations, advertising, and offers of any insurance product or annuity to a consumer by a depository institution, or any person engaged in those activities at the office of a depository institution or on behalf of a depository institution.
• Revises licensing provisions with regard to production agencies, surplus line brokers, and reinsurance intermediaries, and also revises requirements for certain licensees within those categories. Because this bill expands the duties of a surplus line broker and thereby expand the definitions of crimes associated with a violation of these duties, the bill imposes a state-mandated local program.
• Provides that no reimbursement is required by this act for a specified reason.

SB 423 (Johnston, Chapter 694), Life insurance: guaranteed living benefits
An act to add Section 10506.5 to the Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

• Authorizes a life insurer to deliver or issue for delivery variable contracts or riders to variable contracts containing guaranteed living benefits, as defined, under certain conditions.

AB 2107 (Scott, Chapter 442), Elder Abuse
An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

• Imposes the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.
• Only permits life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product's treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to, certain exempt resources, certain protections against spousal impoverishment, and certain circumstances under which an interest in a home may be transferred without affecting Medi-Cal eligibility. The bill excludes from the application of these disclosure provisions credit life insurance, as defined.
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- Requires the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.
- Revises the definition of existing law that defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse.

Year: 1998

SB 1718 (Calderon, Chapter 386), Life insurance.
An act to amend Sections 10509.6 and 10541 of the Insurance Code, relating to life insurance.
- Existing law provides that every life insurer that uses an agent shall, among other things, when a replacement of insurance is involved, provide a notice delivered with the policy that the applicant has a right to an unconditional refund of all premiums, which right may be exercised within 20 days of the date of delivery of the policy. Existing law contains other provisions applicable to variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts that authorize the return of the contract during the cancellation period. This bill adds the latter provision to the previous provisions requiring the applicant to be given notice of a right to an unconditional refund, and changes the 20-day period for the exercise of the right to obtain a refund to a 30-day period.
- Existing law permits certain insurers to issue funding agreements and provides that this authorization does not affect the priority of claims against insolvent insurers. This bill corrects a cross-reference relating to this priority of claims.

Year: 1997

SB 203 (Lewis, Chapter 28), Insurers: mortality tables.
An act to amend Sections 10163.2, 10489.2, and 10489.3 of the Insurance Code, relating to insurance.
- Existing law regulates the types of benefits to be paid under a policy of life insurance in the event of a default in premium payments or upon surrender of the policy, and also regulates the manner in which reserves are to be maintained by insurers issuing life insurance policies and annuity and pure endowment contracts.
- Existing law provides for insurers to use certain mortality tables for these purposes that have been approved by the Insurance Commissioner through promulgation of a regulation. This bill alternatively allows the commissioner to approve mortality tables through issuance of a bulletin.

Year: 1994

SB 1505 (Calderon, Chapter 984), Life insurance and annuity contracts: senior citizen
policies and annuities
An act to amend Sections 10127.10, 10127.11, 10127.12, 10127.13, and 10506.3 of the Insurance Code, relating to life insurance, and declaring the urgency thereof, to take effect immediately.

- Makes specified changes in the cancellation procedures and notice requirements and, in addition, applies those procedures and requirements to individual annuity contracts. In addition, for variable annuity contracts, variable life insurance contracts, and modified guaranteed contracts, a cancelling purchaser would be entitled to a refund of any policy fee paid as well as payment for the value of the account. These provisions do not apply to specified types of group life insurance or group annuity contracts. Under specified circumstances, senior citizens are entitled to refunds if they cancel policies of group term life insurance during the first 30 days of the policy period. The bill also makes conforming changes.

- Also adds the options of stating only the location in the policy text of the required information in 12-point bold type on the cover page of the policy, or by disclosing that information on a sticker that is affixed to the cover page of the policy or to the policy jacket.

- Provides that modified guaranteed annuities are subject to the forfeiture provisions for individual deferred annuities computed under the terms of the annuity, but excluding market adjustment factors, as specified. In addition, group annuities exempted from the provisions governing individual deferred annuities are also exempted from any modified guaranteed annuity regulations.

- This exemption is retroactive to January 1, 1987, to the extent that the assets underlying the group contracts have not been maintained in a separate account. The bill provides that it is to take effect immediately as an urgency statute.

AB 1667 (Hoge, Chapter 6), California Insurance Guarantee Association
An act to amend Sections 1063, 1063.1, 1063.2, 1063.4, 1063.5, 1063.7, 1067.04, 1067.05, and 10112.5 of, to add Section 1067.055 to, and to repeal and add Section 1063.3 of, the Insurance Code, relating to insurance, and declaring the urgency thereof, to take effect immediately.

- Existing law establishes a California Insurance Guarantee Association and specifies those insurers that are required to be members of the association. It exempts certain classes of insurance from assessments and other requirements of the association. This bill specifically enumerates those exempt classes of insurance, and provides that any insurer admitted to transact only those classes or kinds of insurance excluded from specified provisions shall not be a member of the association.

- Existing law provides that the association shall be managed by a board of governors serving for 3 year terms. Those terms expire each year. This bill provides that those terms expire each year on December 31.

- This bill also, among other things, does all of the following with respect to the California Insurance Guarantee Association: (a) Revises the definition of "insolvent insurer," and "covered claims," and defines "ocean marine insurance," as specified. (b) Revises certain policy construction and cancellation provisions with respect to insurer insolvency. (c) Revises the authorization of the association to submit reports
and make recommendations to the Insurance Commissioner regarding the financial condition of member insurers, and certain examination and other report requirements, as specified.  (d) Revises insolvency premium provisions, as specified.  (e) Specifies certain notice provisions with respect to an ancillary liquidator.

- Existing law provides for the California Life and Health Insurance Guarantee Association. The statute that established that association abolished the California Life Insurance Guaranty Association and the Robbins-Seastrand Health Insurance Guaranty Association. This bill provides that the California Life and Health Insurance Guarantee Association is created by the merger of the Robbins-Seastrand Health Insurance Guaranty Association with and into the California Life Insurance Guaranty Association and that the association succeeds to the rights, property, and obligations of the predecessors, as specified.

- Revises provisions dealing with the applicability of specified disability insurance policies issued outside of California to an employer whose principle place of business and majority of employees are located outside of California.

**Year: 1993**

**SB 1065 (Mello, Chapter 516), Life insurance.**

An act to add Sections 10127.10, 10127.11, 10127.12, and 10127.13 to the Insurance Code, relating to insurance.

- Adds additional provisions which permit a senior citizen, as defined, to cancel any policy of life insurance within 30 days following delivery, as specified. It requires those policies to contain a notice of that provision. Those provisions are inapplicable to individual life insurance policies issued in connection with a credit transaction or issued under a contractual policy change or conversion privilege provisions contained in a policy.

- Additionally makes those provisions inapplicable to noncontributory employer group life insurance contracts.

- Requires offerings of life insurance policies to senior citizens that contain illustrations of nonguaranteed values to contain certain disclosures. It requires annual statements to senior citizen policyowners to disclose the current accumulation value and current cash surrender value and requires life insurance policies for senior citizens, which contain a surrender charge period to disclose the surrender period and penalties associated therewith.
Life Agent Disclosure Requirements for Sales to Elders

Assembly Bill 2107

Effective July 1, 2001, Chapter 442, Statutes of 2000 (Assembly Bill 2107, Scott), strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders and clarifies the definition of financial abuse. (The definition of "elders" is any person residing in this state that is 65 years of age or older.) At the time of the enactment of this law, a life agent is required to make specified disclosures about the potential consequences of entering into financial transactions related to an elder's potential eligibility for Medi-Cal coverage and prohibits a life agent from negligently misrepresenting a product based on its treatment under Medi-Cal.

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Required Medi-Cal Disclosure

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

**NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY**

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse does not have to use up all of your savings before applying for Medi-Cal.

**UNMARRIED RESIDENT**

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than $2,000 in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of $35 plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

**MARRIED RESIDENT**

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than $92,760 + $2,000 (for 2004).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or $2319 (for 2004), whichever is greater.

**FAIR HEARINGS AND COURT ORDERS**

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain
additional resources or income. The order may allow the couple to retain more than $92,760 + $2,000 (for 2004) in countable resources. The order also may allow the at-home spouse to retain more than $2319 (for 2004) in monthly income.

REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant’s spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS

ONE MOTOR VEHICLE

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.
THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors with an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy.

Dated: ________________________________
Signature: ______________________________
Signature: ______________________________

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.

The State Department of Health Services (http://www.dhs.ca.gov/mcs/default.htm) shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet Web site.

Life Agent's Duties

Pursuant to Section 10193 of the California Insurance Code, with regard to Medicare supplement insurance and long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.
Elder Abuse

Pursuant to Section 15610.30 of the California Welfare & Institutions Code:

(a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

1. Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.
2. Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.

1. A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.
2. For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity's authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

Life Agent Financial Products Disclosure

Pursuant to Section 789.8 of the California Insurance Code, if a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product.

A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.

A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal Program shall provide, in writing, the required disclosure.
An act to add Section 6177 to the Business and Professions Code, and to amend and renumber Section 10193 of, to amend Section 10234.8 of, and to add Section 789.8 to, the Insurance Code, and to amend Section 15610.30 of the Welfare and Institutions Code, relating to elder abuse.

LEGISLATIVE COUNSEL’S DIGEST

AB 2107, Scott. Elder abuse.

(1) Existing law imposes on all insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with a policyholder, a duty of honesty, good faith, and fair dealing.

This bill would impose the duty of honesty, good faith, and fair dealing on insurers, brokers, agents, and others engaged in the business of Medicare supplemental insurance and long-term care insurance with respect to prospective policyholders.

The bill would only permit life agents, on or after July 1, 2001, to sell or offer for sale to an elder or his or her agent any financial product on the basis of the product’s treatment under Medi-Cal after providing the elder or his or her agent with a specified disclosure, in writing, explaining the resource and income requirements of the Medi-Cal program, including, but not limited to,
The bill would exclude from the application of these disclosure provisions credit life insurance, as defined.

(2) Existing law prohibits conflicts of interest between an attorney and client. This bill would require the State Bar to make a report, by December 31 of each year, to the Legislature on the provision of financial services by lawyers to elders, as specified. The report would include the number of complaints filed and investigations initiated, the type of charges made, and the number and nature of disciplinary actions taken by the State Bar.

(3) Existing law defines financial abuse for the purpose of reporting and investigating elder and dependent adult abuse. This bill would revise that definition.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6177 is added to the Business and Professions Code, to read:

6177. The State Bar by December 31 of each year shall report to the Legislature on the number of complaints filed against California attorneys alleging a violation of this article. The report shall also include the type of charges made in each complaint, the number of resulting investigations initiated, and the number and nature of any disciplinary actions taken by the State Bar for violations of this article.

SEC. 2. Section 789.8 is added to the Insurance Code, to read:

789.8. (a) "Elder" for purposes of this section means any person residing in this state, 65 years of age or older.

(b) If a life agent offers to sell to an elder any life insurance or annuity product, the life agent shall advise an elder or elder's agent in writing that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of this product may have tax consequences, early withdrawal penalties, or other costs or penalties as a result of the sale or liquidation, and that the elder or elder's agent may wish to consult independent legal or financial advice before selling or liquidating any assets and prior to the purchase of any life or annuity products being solicited, offered for sale, or sold. This section does not apply to a credit life insurance product as defined in Section 779.2.

(c) A life agent who offers for sale or sells a financial product to an elder on the basis of the product's treatment under the Medi-Cal program may not negligently misrepresent the treatment of any asset under the statutes and rules and regulations of the Medi-Cal program, as it pertains to the determination of the elder's eligibility for any program of public assistance.
(d) A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

"NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.

UNMARRIED RESIDENT

An unmarried resident may be eligible for Medi-Cal benefits if he or she has less than (insert amount of individual's resource allowance) in countable resources.

The Medi-Cal recipient is allowed to keep from his or her monthly income a personal allowance of (insert amount of personal needs allowance) plus the amount of any health insurance premiums paid. The remainder of the monthly income is paid to the nursing facility as a monthly share of cost.

MARRIED RESIDENT

COMMUNITY SPOUSE RESOURCE ALLOWANCE: If one spouse lives in a nursing facility, and the other spouse does not live in a facility, the Medi-Cal program will pay some or all of the nursing facility costs as long as the couple together does not have more than (insert amount of community countable assets).

MINIMUM MONTHLY MAINTENANCE NEEDS ALLOWANCE: If a spouse is eligible for Medi-Cal payment of nursing facility costs, the spouse living at home is allowed to keep a monthly income of at least his or her individual monthly income or (insert amount of the minimum monthly maintenance needs allowance), whichever is greater.

FAIR HEARINGS AND COURT ORDERS

Under certain circumstances, an at-home spouse can obtain an order from an administrative law judge or court that will allow the at-home spouse to retain additional resources or income. The order may allow the couple to retain more than (insert amount of community spouse resource allowance plus individual's resource allowance) in countable resources. The order also may allow the at-home spouse to retain more than (insert amount of the monthly maintenance need allowance) in monthly income.
REAL AND PERSONAL PROPERTY EXEMPTIONS

Many of your assets may already be exempt. Exempt means that the assets are not counted when determining eligibility for Medi-Cal.

REAL PROPERTY EXEMPTIONS

ONE PRINCIPAL RESIDENCE. One property used as a home is exempt. The home will remain exempt in determining eligibility if the applicant intends to return home someday.

The home also continues to be exempt if the applicant's spouse or dependent relative continues to live in it.

Money received from the sale of a home can be exempt for up to six months if the money is going to be used for the purchase of another home.

REAL PROPERTY USED IN A BUSINESS OR TRADE. Real estate used in a trade or business is exempt regardless of its equity value and whether it produces income.

PERSONAL PROPERTY AND OTHER EXEMPT ASSETS

IRAs, KEOGHs, AND OTHER WORK-RELATED PENSION PLANS. These funds are exempt if the family member whose name it is in does not want Medi-Cal. If held in the name of a person who wants Medi-Cal and payments of principal and interest are being received, the balance is considered unavailable and is not counted. It is not necessary to annuitize, convert to an annuity, or otherwise change the form of the assets in order for them to be unavailable.

PERSONAL PROPERTY USED IN A TRADE OR BUSINESS.

ONE MOTOR VEHICLE.

IRREVOCABLE BURIAL TRUSTS OR IRREVOCABLE PREPAID BURIAL CONTRACTS.

THERE MAY BE OTHER ASSETS THAT MAY BE EXEMPT.

This is only a brief description of the Medi-Cal eligibility rules, for more detailed information, you should call your county welfare department. Also, you are advised to contact a legal services program for seniors or an attorney that is not connected with the sale of this product.

I have read the above notice and have received a copy. Dated:
____________________ Signature: ____________________

The statement required in this subdivision shall be printed in at least 12-point type, shall be clearly separate from any other document or writing, and shall be signed by the prospective purchaser and that person's spouse, and legal representative, if any.
(e) The State Department of Health Services shall update this form to ensure consistency with state and federal law and make the disclosure available to agents and brokers through its Internet website.

(f) Nothing in this section allows or is intended to allow the unlawful practice of law.

(g) Subdivisions (b) and (d) shall become operative on July 1, 2001.

SEC. 3. Section 10193 of the Insurance Code is amended and renumbered to read:

10192.55. (a) With regard to Medicare supplement insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 4. Section 10234.8 of the Insurance Code is amended to read:

10234.8. (a) With regard to long-term care insurance, all insurers, brokers, agents, and others engaged in the business of insurance owe a policyholder or a prospective policyholder a duty of honesty, and a duty of good faith and fair dealing.

(b) Conduct of an insurer, broker, or agent during the offer and sale of a policy previous to the purchase is relevant to any action alleging a breach of the duty of honesty, and a duty of good faith and fair dealing.

SEC. 5. Section 15610.30 of the Welfare and Institutions Code is amended to read:

15610.30. (a) "Financial abuse" of an elder or dependent adult occurs when a person or entity does any of the following:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(b) A person or entity shall be deemed to have taken, secreted, appropriated, or retained property for a wrongful use if, among other things, the person or entity takes, secretes, appropriates or retains possession of property in bad faith.
(1) A person or entity shall be deemed to have acted in bad faith if the person or entity knew or should have known that the elder or dependent adult had the right to have the property transferred or made readily available to the elder or dependent adult or to his or her representative.

(2) For purposes of this section, a person or entity should have known of a right specified in paragraph (1) if, on the basis of the information received by the person or entity or the person or entity’s authorized third party, or both, it is obvious to a reasonable person that the elder or dependent adult has a right specified in paragraph (1).

(c) For purposes of this section, "representative" means a person or entity that is either of the following:

(1) A conservator, trustee, or other representative of the estate of an elder or dependent adult.

(2) An attorney-in-fact of an elder or dependent adult who acts within the authority of the power of attorney.
Pursuant to California Insurance regulation, I am required to advise you of the following:

In the event I recommend that you sell or liquidate any stocks, bonds, IRA, certificate of deposit, mutual fund annuity, or other assets to fund the purchase of an annuity from an insurance company, you may be subject to some or all of the following:

1. Tax consequences;

2. Early withdrawal penalties;

3. Or, other costs or penalties.

You may wish to consult an independent legal or financial advisor before selling or liquidating any assets and prior to purchasing an annuity.

I acknowledge receipt of this disclosure and understand its contents.

________________________________________
Signature of Prospective California Client                  Date

________________________________________
Signature of Agent                                          Date
(SAMPLE FROM INSURER)

NOTICE REGARDING STANDARDS FOR MEDI-CAL ELIGIBILITY
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I have read the above notice and have received a copy.

Dated: ________________________________

Signature: ______________________________

Signature: ______________________________
ANSWER KEY TO REVIEW QUESTIONS

Answers are in BOLD

Chapter 1 – Review Questions
1. Initially, annuities were sold at a fixed price, with no consideration given to _____.  (Ch 1, page 1, pp 4)
   [a] Type of annuity
   [b] Age or gender
   [c] Accumulation period
   [d] Mortality tables

2. Regulatory attention is currently focused on _____.  (Ch 1, page 3, pp 5)
   [a] The SEC
   [b] TEFRA
   [c] Fixed annuities
   [d] Variable annuities

3. The typical annuity owner is ____.  (Ch 1, page 5, pp 1)
   [a] Male
   [b] Female
   [c] A married couple
   [d] A group of Presbyterian ministers

Chapter 2 – Review Questions
1. All of the following are true of an annuity contract EXCEPT _____.  (Ch 2, page 8, pp 1)
   [a] An annuity is a life insurance product
   [b] An annuity liquidates the principal sum and distributes it in periodic payments
   [c] Annuity payments begin at a specific time
   [d] Annuity payments must be made in a lump sum

2. All of the following are reasons people purchase an annuity EXCEPT _____.  (Ch 2, page 9, pp 1)
   [a] Liquidity of principal
   [b] Tax treatment
   [c] Safety of product
   [d] Guarantees

3. One advantage an annuity has over other retirement vehicles is ____.  (Ch 2, page 13, pp 8)
   [a] Its liquidity
It provides a lifetime income
Contributions are made tax-free
Distributions are always received tax-free

Chapter 3 – Review Questions
1. The appeal of an annuity centers on its _____. (Ch 3, page 17, pp 1)
   [a] Status as a life insurance policy
   [b] Ability to provide tax-deferred growth of principal
   [c] Status as a securities product
   [d] Ability to provide tax-free growth of principal

2. A flexible premium annuity _____. (Ch 3, page 18, pp 2)
   [a] Is purchased with a lump sum payment
   [b] Is purchased with premiums made over a period of time
   [c] Is purchased to make flexible payments over time
   [d] Is purchased to guarantee the consumer with flexibility

3. A(n) _____ annuity is purchased with a lump sum payment and the consumer begins receiving distributions right away. (Ch 3, page 18, pp 4)
   [a] Variable
   [b] Immediate
   [c] Single premium
   [d] Indexed annuity

4. _____ may sell variable annuities. (Ch 3, page 20, pp 3)
   [a] A person holding a life insurance producer’s license
   [b] A person holding a securities license
   [c] A person holding a life insurance producer’s license and a securities license
   [d] A person holding a broker/dealer license

Chapter 4 – Review Questions
1. All of the following are parties to an annuity contract except _____. (Ch 4, page 24, pp 1)
   [a] Insurance Company
   [b] State of California
   [c] Annuitant
   [d] Beneficiary

2. The ____ has most of the rights in an annuity contract. (Ch 4, page 24, pp 3)
   [a] Owner
   [b] Annuitant
   [c] Beneficiary
   [d] Insurance Company
3. For purposes of compliance with the Free Look period of an annuity sold to a senior in the State of California, a senior is an individual who is _____ years of age or older on the date the annuity was purchased. (Ch, page 27, pp 6)
   [a] 55  
   [b] 60  
   [c] 65  
   [d] 70

4. The Free Look period for an annuity sold to a senior in the State of California that involves replacement is _____ days. (Ch 4, page 29, pp 4)
   [a] 10  
   [b] 20  
   [c] 30  
   [d] 60

5. When a _____ is chosen by an annuitant, payments are guaranteed to continue for a specified time, regardless of how long the annuitant lives. (Ch 4, page 32, pp 5)
   [a] Life annuity payout  
   [b] Joint and survivor annuity payout  
   [c] Refund annuity payout  
   [d] Period certain payout

Chapter 5 – Review Questions
1. Most insurance companies require maximum issue ages of annuitants and owners based upon ____. (Ch 5, page 37, pp 3)
   [a] Insurance company underwriting guidelines  
   [b] California Insurance Code  
   [c] Life expectancy tables and minimum required distribution limits  
   [d] Age of the beneficiary

2. All of the following are examples of annuity contract charges and fees EXCEPT ____. (Ch 5, page 42, pp 3)
   [a] Mortality and expense risk charge  
   [b] Administrative fees  
   [c] Underlying fund expense fees  
   [d] Late payment charge

3. The credited rate of interest being based on the insurance company’s best estimate of the investment return they hope to make during the coming year best describes ____. (Ch 5, page 46, pp 3)
   [a] Portfolio rate  
   [b] Bonus rate  
   [c] New money rate
4. **Point to point indexing is _____**. (Ch 5, page 53, pp 6)
   [a] The actual value of the index on the policy inception date
   [b] The same as monthly averaging
   [c] Included in a participation rate
   [d] The change in the index value is measured based on two specific points in time

5. A longevity rider _____.
   [a] Is the same as a long-term care rider
   [b] Provides guaranteed future income beginning at a high age, such as 85
   [c] Is offered by every life insurance company
   [d] Guarantees a retirement income before the annuitant’s age 85

**Chapter 6 – Review Questions**

1. A qualified annuity is purchased with _____. (Ch 6, page 58, pp 2)
   [a] A lump sum premium
   [b] Flexible premiums
   [c] Pre-tax dollars
   [d] After-tax dollars

2. In defined contribution plan, investment decisions are usually made by _____. (Ch 6, page 59, pp 4)
   [a] The employer
   [b] The employee
   [c] The IRS
   [d] The insurance company

3. A Tax Sheltered Annuity Plan is also known as a _____. (Ch 6, page 61, pp 2)
   [a] 401(k) plan
   [b] Roth 401(k) plan
   [c] 403(b) plan
   [d] Defined benefit plan

**Chapter 7 – Review Questions**

1. All of the following are terms referring to the monies paid into an annuity EXCEPT _____. (Ch 7, page 65, pp 1)
   [a] Premium
   [b] Principal
   [c] Interest
   [d] Original contribution
2. **Section 1035 exchanges require that _____.** (Ch 7, page 68, pp 5)
   [a] A gain is recognized on the exchange
   [b] A loss is recognized on the exchange
   [c] The exchange cannot be “like to like”
   [d] Constructive receipt of funds cannot be accepted by the contract owner

3. The **Uniform Gifts to Minors Act (UGMA)** allows which of the following _____. (Ch 7, page 70, pp 4)
   [a] The gifted annuity is held in the child’s name
   [b] Use of the donor’s social security number for tax purposes
   [c] The child does not have to pay the 10% premature withdrawal penalty
   [d] The child does not have to pay taxes on the annuity’s earnings

4. The **exclusion ratio formula** is used _____. (Ch 7, page 74, pp 1)
   [a] When calculating which portion of annuity distributions are taxable
   [b] When calculating the expected return
   [c] When calculating the investment in the contract
   [d] When calculating the tax-free return of principal

### Chapter 8 – Review Questions

1. **All of the following are advantages of annuity contracts EXCEPT _____.** (Ch 8, page 78, pp 2)
   [a] Tax-deferred growth of principal and interest
   [b] No minimum contribution limits
   [c] No step-up basis at death
   [d] Appropriate for a long-term investor

2. ____ is considered a safe and secure investment. (Ch 8, page 82, pp 3)
   [a] Stock
   [b] Money market account
   [c] Commodities
   [d] Promissory note

3. **A viatical settlement involves _____.** (Ch 8, page 88, pp 4)
   [a] The purchase of a life insurance policy for less than its face amount
   [b] The purchase of a life insurance policy for more than its face amount
   [c] The purchase of a Master Limited Partnership (MLP)
   [d] The purchase of a Direct Participation Program (DPP)

### Chapter 9 – Review Questions

1. If replacement is, or may be, involved in the sale of an annuity, the producer must supply the insurance company with _____. (Ch 9, page 95, pp 5)
   [a] A copy of the replacement notice required by CIC
[b] A copy of the replaced policy
[c] A copy of his producer license
[d] A copy of the applicant’s driver’s license

2. A Free Look period of _____ days is required when replacement of an annuity is involved. (Ch 9, page 97, pp 1)
   [a] 10
   [b] 20
   [c] 30
   [d] 45

3. When advertising, _____ must be included on every business card, piece of stationery, advertisement, or illustration. (Ch 9, page 98, pp 4)
   [a] The producer’s name
   [b] The producer’s license number
   [c] The producer’s social security number
   [d] The producer’s title

4. All of the following must be kept as part of the record keeping process, EXCEPT ____. (Ch 9, page 115, pp 3)
   [a] Disclosure forms
   [b] Occupation details of the applicant
   [c] Risk tolerance and other worksheets
   [d] A voided check belonging to the applicant

Chapter 10 – Review Questions

1. All of the following are considerations when setting retirement goals in the earliest phase of retirement planning EXCEPT _____. (Ch 10, page 118, pp 3)
   [a] What retirement fund options are available?
   [b] How will assets be allocated both before and after retirement?
   [c] Were retirement costs and standard of living predicted accurately?
   [d] What is the desired retirement age?

2. An individual can opt to begin receiving Social Security retirement benefits at age ____. (Ch 10, page 119, pp 4)
   [a] 60
   [b] 62
   [c] 65
   [d] 70

3. All of the following are examples of elder abuse EXCEPT ____. (Ch 10, page 126, pp 3)
   [a] Misusing or stealing a senior’s money or possessions
   [b] Cashing a senior’s checks with permission
Chapter 11 – Review Questions

1. The guarantee association is composed of _____. (Ch 11, page 131, pp 1)
   [a] All insurance companies licensed to sell life insurance, health insurance, and annuities in the United States
   [b] All insurance companies licensed to sell life insurance, health insurance, and annuities in the state of California
   [c] All insurance companies not licensed to sell life insurance, health insurance, and annuities in the state of California
   [d] All insurance companies licensed to sell life insurance and annuities in the state of California

2. The maximum limit of protection, per policyholder, is _____. (Ch 11, page 132, pp 2)
   [a] 80% of the values in each annuity
   [b] 80% of the values in each annuity, subject to a maximum of $100,000 per annuity
   [c] 80% of the values in each annuity issued by the same insurance company
   [d] 80% of the values in each annuity, subject to a maximum of $100,000 for all annuities issued by the same insurance company