

Annuity 8-Hr Training Course **201**



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PART I: Historical Development

THE EVOLUTION OF ANNUITY PRODUCTS

Impressive Beginnings

English and European cultures have long embraced the annuity. You may have read English literature novels, for instance, where annuities were described as the favored investment vehicle of many mid-18th century upper class families. Stories were told of the comfortable, secure life led by annuity holders in marked contrast to many volatile and speculative investments of the time.¹

Annuities in America appeared during the 18th century, however, not as investments for the general public. Actually, a group of Presbyterian ministers and their families were the first to be able to contribute to a special fund in exchange for lifetime payments. It wasn't until the early 1900's, however, that the first commercially sold annuities were offered through the Pennsylvania Company for Insurance.²

In the late 1930's, concerns of our Nation's financial markets prompted a surge in individual annuity purchases because, in the middle of the depression, insurance companies were thought to be stable institutions that good make good on their promises to pay. Americans were preoccupied with finding a safe place to save and annuities were viewed as such. Unfortunately, insurers sustained losses on most annuity contracts with the "squeeze" of falling rates of return and the rising longevity of annuitants -- an assumption not made by most insurance underwriters. By the end of WWII, annuities made a comeback on the heels of new group sales connected to defined benefit pension plans.

Keep in mind that annuities back then and for many years thereafter were quite different than the sophisticated choices of today. Contracts, for example, simply guaranteed a return of principal along with a fixed return from the insurance company. Withdrawals were usually limited to a choice between a fixed income for life or payments over a set number of years. Annuity investing was about as simple as it could be.

Taxation and Interest Sensitive Attractions

Annuities have also maintained an advantage over other forms of investing in that the interest earned is tax deferred. This was a special exemption built-in for insurance companies that has allowed annuity buyers to accumulate savings without taxes. In essence, they have been able to put the time value of money on their side. Everything was fine, as long as you were happy with a fixed return.

Years later, a new wrinkle was added . . . interest sensitive earnings. Believe or not, the variable annuity was created way back in 1952. Annuity holders could now get interest credit based on the performance of a separate account within the annuity. They could also choose what kind of account they wanted and often received modest guarantees in exchange for a greater risk.

¹ Forepa.com, History of Annuities

² Savewealth.com, History of Annuities

Historical Motivation

If you ask someone to react to the prospect of an investment that offers them a guaranteed annual income after they retire, no matter how long they live, you might expect, a lot of interest. That is the appeal of annuities.

Annuities are often called "life insurance in reverse." Life insurance creates an estate immediately upon the insured's death, thus replacing some portion of that person's future income. This protection is particularly important when the insured dies prematurely and is survived by individuals who are dependent on his or her anticipated future income. Thus, life insurance can be considered protection against "not living long enough."

An annuity, in contrast, protects against "living too long." While many people agree that a long life is a blessing, they also acknowledge that they do not wish to outlast the savings they have accumulated for retirement. This concern underlies one of the basic attractions of annuities. By assuring continued payments for an unlimited number of years, annuities guarantee that the insured will not deplete his or her source of income.

Exactly when does someone decide to buy an annuity? And why? There is no set formula. And it is probably a gross oversimplification to say that in times of financial uncertainty, annuities seem to fare better as they did in the 1930's. Certainly, recent times and product changes like EIA's have added a whole new dimension to the reasons and motivation to buy.

Risk and Return

Market conditions and economies change, but there is a constant factor that determines a buyer's willingness to purchase annuities . . . risk and return. Consider the following influences that can affect rates and return:

- Prior to the 1980's, the life insurance industry existed nearly 150 years in a very stable economy. For example, the prime rate from 1930 to 1969 ranged between 1.5 and 8.5 percent, averaging 3.62 percent. In the 1970's and 80's, the prime rate was anything but predictable, ranging from a low of 5 percent to a staggering high of 21.5 percent! Today, and who knows for how long, it is again in the low digits. This historical perspective is significant because, like many interest-sensitive industry's, the prime rate drives an insurer's ability to create competitive offerings.
- The insurance industry was built under legislation, regulation and business plans designed for the 3.62 percent average prime rate and a stable economy, it is easy to understand why annuity performance and the motivation to buy them was less than satisfactory at times.
- The government has often mandated that insurance companies invest in portfolios of long-term bonds and mortgages . . . not exactly interest sensitive products that could permit a rapid response to rising consumer rate / reward demands.
- A proliferation of insurance company rating services and insurance company failures during the 1980's created a public demand for companies with the highest ratings. Of course, companies like Standard & Poor's Rating Group, Moody's Investors Service, Duff & Phelps Credit Rating Company, Fitch Financial Wire Services, and A. M. Best Company look to financial stability, not risk / reward opportunities for consumers.

- The establishment of risk-based capital ratios. If the insurance company has assets defined as risky by the state, the company needs to have more surplus than assets deemed safe, such as short-term government bonds. The result is a clean, AAA insurance company general account that is paying an acceptable rate of interest from an investment of this kind. Under these conditions, interest rates are bound to be lower, probably close to the minimum contract guarantee.
- Suitability standard regulations concerning fixed and variable annuity products are growing. While important to overall stability, these statutes tend to restrict innovative product offerings that could improve risk / reward attractiveness.

PRODUCTS AND PRACTICES

Nowhere has the increased offering of products been more profound than in the life insurance industry. Life insurance companies now offer consumers a dazzling array of savings and investment products tied to their life insurance policies. What was normally thought of as the cash value of a life insurance policy earning a very low rate of return, can now be invested in a variety of savings and investment vehicles offering real growth possibilities compared to much lower returns of the past. It was not long ago that anyone referring to life insurance as an "investment vehicle" was laughed at or criticized. Similarly, annuity products were conceptually limited as vehicles to pay out retirement benefits from pension plans. Insurance company products were considered to be relatively staid and boring. However, times have changed. These products now have an important role in personal investment planning.

Legislation for Better Products and Services

Many states, and particularly California, are also concerned about the suitability of annuity products and services witness the recent legislation litany:

SB 1065 (1993) Requires special disclosures to senior citizens concerning accumulation and surrender values as well as provisions to cancel.

AB 1667 (1994) Defines the role of the California Insurance Guarantee Association and establishes certain product exemptions.

SB 1505 (1994) Makes more changes to cancellation procedures and notice requirements applicable to annuity sales.

SB 203 (1997) Revises previous law concerning annuity benefits in the event of default or surrender and allows the Commissioner to modify mortality tables.

SB 1718 (1998) Changes the unconditional right to refund from 20 to 30 days.

AB 2107 (2000) Reinforces the agent's duty of honesty and fair dealing and establishes special handling where Medi-Cal eligibility is concerned.

SB 423 (2000) Authorizes variable contract living benefits

AB 2984 (2002) Regulates annuity and life sales by depository institutions.

AB 284 (2003) Tightens paid-up and surrender benefits and provides for a uniform method of calculating nonforfeiture amounts.

SB 618 (2003) Establishes new penalties and control over the unfair acts licensees, especially for clients age 65 and older.

SB 620 (2003) Redefines annuity suitability and sales practices to seniors including the prohibition of sale in certain circumstances. Also establishes the requirement for the special annuity training present in this course.

SB 483 (2008) Designed to bring California into compliance with provisions of the Deficit Reduction Act of 2006 which lengthened the “look-back” period for asset transfers to establish Medicaid's eligibility for nursing home coverage from 3 to 5 years, requiring annuities to be disclosed and states to be named a beneficiary for the cost of Medicaid assistance with certain specific exceptions.

AB 689 (2011) Effective January 1, 2012. AB 689 adopts several of the provisions of the National Association of Insurance Commissioners (NAIC) Suitability in Annuity Transactions model regulations adopted by California. Similar to AB 1416, the changes in AB 689 do not change the existing annuity training requirements.

Section 1749.8 (2012) of the California Insurance Code (CIC) requires that every insurance producer who sells annuities shall satisfactorily complete eight hours of training prior to soliciting consumers to sell annuities. This section further requires insurance producers to complete four hours of training every two years prior to their license renewal.

AB 1416 (2011) included an amendment to Section 1749.8 to state that the four hours of annuity training is to be completed prior to each license renewal.

Section 10509.915(a) CIC (2012) An insurance producer shall not solicit the sale of an annuity product unless the insurance producer has adequate **knowledge of the product** to recommend the annuity and the insurance producer is in compliance with the insurer's standards for product training. **Insurance producers may rely on insurer-provided product-specific training** standards and materials to comply with the product-specific training requirement.

Section 10509.915(b)(2012) In addition to the above, an insurance producer shall complete a one-time eight credit-hour annuity training course by an approved education provider, prior to commencing the transaction of annuities. Further, every producer who engages in this state in the sale of annuity products shall satisfactorily complete a four-hour refresher annuity course prior to license renewal every two years.

MARKET OVERVIEW

Products and services have evolved. Today we see even more incentives with the advent of checkbook access, bonus entry rates, shorter maturity periods, nursing home and emergency fund withdrawals, long term care riders and guaranteed death benefits. Variable and indexed type annuities have also made inroads.

The Life Insurance Marketing Research Association (LIMRA) reports that total annual fixed annuity sales topped \$76 billion in 2011. Variable annuity sales amounted to \$41 billion in 2011. This is down from their heydays of the late 1990's where sales climbed to \$155 billion! Indexed annuities paced at \$33 billion in 2011. What does it all mean? Clearly, annuities continue to represent a favorable alternative to traditional investment and retirement vehicles.



PART II: Annuity Classifications

THE BASICS

*An **annuity** is defined by insurance codes as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and continue throughout a specified period of time or for duration of a designated life or lives, i.e., a policy contract that agrees to pay the insured a regular income over a specified period of years.*

When an individual purchases an annuity policy, he or she agrees to pay the insurance company a certain amount of money in exchange for this income. The time period over which the insurance company promises to provide income varies. The contract may specify an exact number of years, or the individual's lifetime -- an unspecified number. The term "annuity" usually **refers** to the contract made between an individual and an insurance company; it is also used to describe the income that the individual receives under the contract.

The payments one makes for an annuity are referred to as premiums. **Premiums** earn interest, and these amounts increase in value while the insurance company invests them. The annuity contract also specifies the interest rate that the insurance company will pay on the accumulated fund. A specific interest rate may be guaranteed for one or two years, and sometimes as long as five years. After the guaranteed-rate period expires, the contract may call for the rate to be reviewed at specified intervals, such as quarterly or annually. At that time, the insurance company adjusts the rate in accordance with changes in the general interest rates. Many insurance companies use the rate paid on treasury bills as an index for setting the rate paid on annuities. Sometimes they use indexes such as consumer prices or cost-of-living calculations. Most insurance companies also guarantee that the interest rate paid on annuities will never be lower than a particular rate specified in the contract. When an insurance company receives premiums on a fixed annuity, it invests them along with other funds it holds. Not all of the dollars a contract owner pays are invested, since some are used for sales commissions and fees. These charges differ among companies and among contracts.

Some companies have no charges other than **surrender fees**. However, should the insured die before the cash value stated in the contract equals the amount of premiums paid in, most contracts provide for a payment to the beneficiary of at least the amounts paid in, regardless of sales charges.

Taxes on the interest earned on annuity contracts are **deferred**, and they are paid when distribution of the funds takes place. For this reason, this product is often referred to as a tax-deferred annuity. In this manual, the shorter, generic term "annuity" is used.

The individual who purchases the annuity is referred to as the **owner**. The person who receives payments from the annuity is the **annuitant**. The annuitant may or may not be the contract owner. Each of these terms will become more meaningful as you learn more about annuities.

CONSUMER GOALS & ANNUITY BENEFITS

A vast variety of annuities exist to meet the diverse needs and goals of consumers. An individual looking for a long-term, tax-deferred "pot of money" for retirement might consider a simple, deferred annuity as opposed to bank CD's or riskier mutual funds / stocks. Variable and

indexed annuity contracts might appeal more to individuals who are willing to take a higher level of risk than a CD for potential greater rewards. The nice thing about present day annuities is the benefit options available to consumers, including the ability to withdraw chunks of money for emergencies along the way or a monthly income that continues for life. These are options not generally available outside the annuity world.

Two basic categories of annuities are immediate annuities and deferred annuities. These types differ in the time that **benefit payments** to the annuitant begin.

Immediate Annuities

An immediate annuity provides for payments to commence shortly after the purchase date, according to an agreed-upon schedule of monthly, quarterly, semiannual or annual payments. For example, a retiree who sells her home may use the sale proceeds to purchase an immediate annuity. This annuity will provide her with immediate, regular income for a specified number of years or for the rest of her life, depending on other provisions in the annuity contract.

Deferred Annuities

With a **deferred annuity**, the contract specifies a future date that payments to the annuitant will begin. This date is referred to as the maturity date. The period before the maturity date on a deferred annuity is sometimes called the accumulation period. The period following the maturity date during which payments are made to the annuitant is known as the liquidation or distribution period. As with **immediate annuities**, the annuitant will receive payments according to the schedule in the contract.

To understand how a deferred annuity is commonly used, consider a middle-aged man who wishes to provide for economic security during his retirement years. While he expects to receive a regular income from Social Security and his company's pension plan, he believes he will need an additional source of income in order to live in the manner he desires. He could contract for a deferred annuity that will begin providing him with a regular income when he reaches age 65. He could purchase this annuity with a lump sum payment or with regularly scheduled payments made until the benefits are scheduled to begin.

TYPES OF ANNUITY PREMIUMS

There are many choices when it comes to participating in annuities. It all depends on the consumer's ability to pay and features desired. In the simplest terms, annuity investors have the option to make a large, single premium or periodic (flexible) premiums over time. Here is a brief description of both:

Single Premium Annuities

A consumer who normally invests in bank CD's may also consider a single premium fixed annuity where a single, cash payment establishes the contract. Fixed-rate annuities are more likely to allow a single premium or onetime investment and **lock-in** a certain return for a specified period of time. A contract owner who likes a particular company or the general provisions of a specific annuity contract can typically **add** money by filling out another application. However, the new contract may or may not offer the same interest rate.

Flexible Premium Annuities

An annuity investor looking for a contract where additional monies can be added is more likely to seek out a flexible premium annuity. Variable annuities are more likely to adopt flexible premiums where many contract buyers find the ***check a month*** type investing allows them to respond to market opportunities or rate changes.

Risk can sometimes be quite higher in flexible plans where mutual funds are chosen. More importantly, this risk is borne almost solely by the investor and not the insurance company. This ***contrasts with many single premium plans***, focusing on fixed-rate products where the insurer bears all of the investment risk.

Premium Restrictions

Under California Law (***Section 10540 CIC***) an insurer may collect insurance premiums in advance. However, they may not accept such moneys in an amount to exceed (1) the sum of future unpaid premiums on any such policy or (2) the sum of 10 such future unpaid annual premiums on any such policy if such sum is less than the sum of future unpaid premiums on any such policy. This does not limit the right of such insurers to accept funds under an agreement which provides for an accumulation of such funds for the purpose of purchasing annuities at future dates.

TYPES OF ANNUITY INVESTMENT OPTIONS

Variable Annuities

The premise for insurers developing variable annuities builds on the idea that not everyone needs a set or fixed rate of return. Some investors are willing to forgo the promise of a minimum guarantee as long as there is upside potential that can be earned.

A variable annuity is a contract between you and an insurance company, under which the insurer agrees to make periodic payments to you, beginning either immediately or at some future date. You purchase a variable annuity contract by making either a single purchase payment or a series of purchase payments.

A variable annuity offers a range of investment options. The value of your investment as a variable annuity owner will vary depending on the performance of the investment options you choose. The investment options for a variable annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three. The only limitation would be the options offered by the variable annuity and the amount a consumer is willing to put into one position.

Example: Robert has \$50,000 to invest. His agent suggests a variable annuity that offers a variety of mutual fund investment options. After much discussion concerning Robert's current liquidity and future plans, agent and customer agree to spread the \$50,000 as follows: \$15,000 in a balanced portfolio fund; \$25,000 in a growth and income position; and \$10,000 in international equities.

Although variable annuities are typically invested in mutual funds, variable annuities differ from mutual funds in several important ways:

- First, variable annuities let you receive periodic payments for the rest of your life (or the life of your spouse or any other person you designate). This feature offers protection against the possibility that, after you retire, you will outlive your assets.
- Second, variable annuities have a death benefit. If you die before the insurer has started making payments to you, your beneficiary is guaranteed to receive a specified amount – typically at least the amount of your purchase payments. Your beneficiary will get a benefit from this feature if, at the time of your death, your account value is less than the guaranteed amount.
- Third, variable annuities are tax-deferred. That means you pay no taxes on the income and investment gains from your annuity until you withdraw your money. You may also transfer your money from one investment option to another within a variable annuity without paying tax at the time of the transfer. When you take your money out of a variable annuity, however, you will be taxed on the earnings at ordinary income tax rates rather than lower capital gains rates. In general, the benefits of tax deferral will outweigh the costs of a variable annuity only if you hold it as a long-term investment to meet retirement and other long-range goals.

Like **mutual funds**, variable annuity insurance companies do not influence investor decisions nor do they directly share in any profits. If the security goes up by 25% in one year, the annuity contract **owner keeps the entire gain**. On the other hand, if the investment plummets 25%, no one makes up the difference or guarantees a minimum return.

Fixed Annuities

Unlike variable contracts, fixed annuities are invested only with the insurer. However, this does not mean there are not investment options. Depending on a client's liquidity needs, fixed contracts with longer maturities will pay higher interest, just like CD's. This may work fine with your client as long as he understands that there will be penalties to get at his money prior to the full maturity.

Also in contrast to variable contracts, fixed annuities offer a guaranteed interest rate for a set period of time. Your client's earnings grow tax deferred until they begin to withdraw their income. During the accumulation period of a fixed deferred annuity, your client's money (less any applicable charges) earns interest at rates set by the insurance company or in a way spelled out in the annuity contract. The company generally resets the interest rate periodically, but guarantees the rate will never fall below a minimum rate stated in your contract. During the payout period, the amount of each income payment to your client is generally set when the payments start and will not change. Because the principal and interest guarantee is only as good as the company, it is important to consider a strong, stable company that will be there tomorrow.

Indexed Annuities

Up until very recently, individuals had two choices when it came to annuities: fixed annuities (offering a guaranteed rate) and variable annuities. But in the mid-90s, a third option was introduced that has begun to gain in popularity: the index annuity.

An equity-indexed annuity is a fixed annuity, either immediate or deferred, that earns interest or provides benefits that are linked to an external equity reference or an equity index. The value of the index might be tied to a stock or other equity index. One of the most commonly used indices is Standard & Poor's 500 Composite Stock Price Index (the S&P 500), which is an equity index. Like variable annuities, the value of an index annuity can vary from day to day and is not predictable. However, unlike a variable contract, when your client buys an equity-indexed annuity he owns an insurance contract. He is not buying shares of any stock or index.

An **equity-indexed annuity** is different from other **fixed annuities** because of the way it credits interest to your annuity's value. Some fixed annuities only credit interest calculated at a rate set in the contract. Other fixed annuities also credit interest at rates set from time to time by the insurance company. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited. How much additional interest you get and when you get it depends on the features of your particular annuity.

Equity-indexed annuities, like fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of the annuity also will not drop below a guaranteed minimum. For example, many single premium annuity contracts guarantee the minimum value will never be less than 90 percent of the premium paid, plus at least 3% in annual interest (less any partial withdrawals). The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitizations (see "Annuity Income Payments") and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

The Client and Annuity Relationship

When considering the many options to invest in indexed annuities, you must consider your client's liquidity and tolerance levels. For example, a person who is accustomed to having gains credited each year and reflected on their annual statement is perhaps a more likely prospect for an annual reset structured EIA. Likewise a person who has been in a variable product, and who understands how day-to-day market fluctuations can affect returns, might prefer the higher return potential offered by point-to-point styled EIAs. More about these features later. When it comes to liquidity, most EIA products have provisions allowing the customer to withdraw a percentage of funds without penalty each year. Additional liquidity riders providing customers enhanced access to their funds in the event of nursing home confinement, unemployment, disability or terminal illness can be valuable.

Depending on a client's liquidity needs, **fixed annuity contracts** with longer maturities will pay higher interest, just like CD's. This may work fine with your client as long as he understands that there will be penalties to get at his money prior to the full maturity.

Like mutual funds, **variable annuity** insurance companies do not influence investor decisions nor do they directly share in any profits. If the security goes up by 25% in one year, the annuity contract **owner keeps the entire gain**. On the other hand, if the investment plummets 25%, no one makes up the difference or guarantees a minimum return. Be sure your client understands this risk and is financially capable of handling losses.



PART III: Parties to an Annuity

In any annuity transaction there are four parties: the *insurer*, the *contract owner* (the person or trustee with the investment control), the *annuitant* (the person on whose life the annuity is based), and the *beneficiary* (the person or trust who receives the annuity in the event of the death of the annuitant).

Many annuity purchasers sign the contract without fully understanding the ramifications of which persons are listed as the owner, annuitant, and beneficiary. Take, for example, a situation where Mr. and Mrs. Jones purchase an annuity. Mr. Jones is listed as the owner, Mrs. Jones the annuitant, and the Jones' good-for-nothing son the primary beneficiary. If Mrs. Jones dies (but Mr. Jones does not), the good-for-nothing son becomes the owner, probably not what the Jones' intended.

As an agent, you need to understand these structuring issues before you invest any client in an annuity.

ROLE OF ANNUITY OWNERS

Annuities come in two contract "forms": Owner-Driven (OD) and Annuitant-Driven (AD). The term "driven" simply mean that certain actions forcibly occur upon death that are beyond the control of named parties to the contract. Strategies to control this involve the proper structuring concerning the *entities eligible for annuities, i.e., who owns, who is an annuitant and who is a beneficiary* to the annuity contract.

In *owner-driven* annuity contracts, benefits are based upon something happening to the owner (death, disability, reaching a certain age, etc). Owners have all legal rights, and can change, as needed, the designated annuitant, as the contract specifies, without any negative tax or penalties. Owner-driven contracts pay out *only* on death of the owner.

Under an owner-driven contract, the annuity remains in force if the annuitant dies. The owner must name a new annuitant, or the contract may specify that the owner also becomes the annuitant. If there is a contingent annuitant, then the contingent annuitant becomes the annuitant; the owner typically may not name a new contingent annuitant. However, if it is a contingent annuitant who dies, not the primary annuitant, the owner may simply name a new contingent annuitant.

Annuitant-driven contracts base benefits on something happening to the annuitant (death, disability, reaching a certain age, etc). These annuities typically spell out that owner(s) can be changed and are contract-specific as to whether or not an annuitant can be changed once the contract is issued. Further, upon the death of either owner(s) or annuitant(s), the contract will pay out.

In either form of contract, changes to beneficiaries may always be made.

In the '70s and early '80s, it was common for someone to own a traditional *annuitant-driven contract* that named a child or grandchild annuitant/beneficiary. Since this annuity matured

when only the younger annuitant died, he or she could likely enjoy many decades of tax-deferral after inheriting the policy.

Effective Jan. 19, 1985, however, Congress changed the rules when it enacted Internal Revenue Code Section 72(s). Under the **death of the holder rule**, all contracts made after this date must force distributions out to non-spouse beneficiaries when a holder-owner dies. However, under the **spousal continuation rule** a recipient who is the holder's surviving spouse can step into the holder's shoes and continue the policy until the surviving spouse's death, or the policy's stated maturity date, if later.

The Importance of Annuity Titling

Proper structuring of your client's annuity can help avoid untimely income taxes, unwanted gift taxes, a 10% IRS penalty and/or the loss of spousal continuation rights. Consider the following examples:

Example: Bill and Marsha buy an annuity and structure it as **annuitant-driven**: Bill is the owner; Marsha is the annuitant and both are listed as the beneficiary.

Under terms of their annuity contract, if Marsha dies first, Bill becomes the sole beneficiary, but under the spousal continuation rule cannot continue the annuity because there is no deceased owner-spouse. As a result, distributions will be forced upon him as the sole remaining and surviving beneficiary upon the death of the wife.

Example: Mark and Patty structure their annuity as **owner-driven**: Both Mark and Patty are owners, Patty is the annuitant and the beneficiary is their children.

If Patty pre-deceases Mark, the children will get the payout. While this may look fine, it's may not be, because the surviving husband/owner lives, and therefore it's the same as having made a lifetime gift to the children (who not control the asset), which creates adverse gift tax consequences in the year of the death, to the husband. In addition, since **neither** Mark or Patty were made the sole primary beneficiary, Mark loses the right of continuation.

The children, if under age 59-1/2, are also liable for the 10 percent penalty tax, as well as ordinary income tax on any future income paid out of the contract, because upon the death of the annuitant, any beneficiary becomes the taxpayer, not the owner!

We will expand on these issues later. For now, it is important to know that there are some serious issues to consider when titling or structuring an annuity.

Structuring Annuities

The goal in structuring or titling an annuity should be to maximize the payout options your client has available when upon death of the annuitant or when exiting the contract and/or at the same time minimize any tax or penalties. Tax and estate favorable annuity payout options might involve **annuitization** or distribution of your client's annuity value over five years, his life expectancy, a fixed period of time (10 years, 15 years, etc) or as a lump sum, say within 60 days of the annuitant' death. Also, you should consider the ability for a surviving spouse to continue the contract for the remainder of his or her lifetime.

One method suggested by some experts is to name one or the other spouse as sole beneficiary, or - conversely - in the case of joint ownership of the annuity, the surviving spousal owner. If there are children, they could be named as contingent beneficiaries, since this can also preserve for them many the annuitization options above upon the death of the last surviving spouse.

Example: Josh and Sally, a husband and wife, invest in an annuity naming Josh as the owner and annuitant. Sally is the primary beneficiary and their children are named as contingents.

If the Sally dies first, the Josh simply names new beneficiaries (most likely the children) and thus maintains control over the asset. If Josh is the first to go then Sally gets the asset and can continue the tax deferral (i.e., she is not forced to take distributions). Further, the children may ultimately receive an even larger asset. For some clients, one problem is their objection to making one or another spouse the sole owner. However, it is typically advised to name the older of the spouses as the owner since the likelihood of the older spouse dying first is statistically higher. Another practical solution is to simply buy two separate contracts, one for each spouse.

Others suggest that the primary or contingent beneficiary be a trust. The problem to point out here is that annuities already pass probate free . . . why have a trust? Also, trusts do not allow for any form of spousal continuation nor lifetime annuitization because they are a **non-natural person**. Further, contracts often limit pay-out options to trusts which could substantially reduce payout flexibility.

What about trusts as owners? Before advising this, it is important to know if the insurance company issuing the annuity views the trust as either a "natural" or a "non-natural person." If it views the owner-trust as a trust, it will not allow for spousal continuation. Some annuity contracts, however; have **look-through provisions** wherein they will "look through" the grantor/trustee designation and recognize the spouse and spousal-continuation rights.

The bottom line here is use caution when employing any trust as part of any annuity structure. It is even suggested that you obtain a written letter of instruction from the client's attorney on exactly how the attorney and the client want the structuring set up under an annuity contract.

ROLE OF ANNUITANTS

The role of annuitant is sometimes difficult to understand. As a matter of reference, the annuitant is like the insured in a life insurance policy. However, unlike a life policy, when the annuitant dies, it does not necessarily mean the annuity contract will come to an end. In his book *Getting Started in Annuities*, Barry Williamson describes the annuitant as the **measuring life** in an annuity contract. Like an insured he has no voice or control of the contract. He does not have the power to make withdrawals or deposits, change the names of the parties to the agreement or terminate the contract. Yet, the annuitant must sign the contract.

The person named in the annuity can typically be anyone: your client, spouse, child, parent, friend or neighbor. However, it cannot be a non-living entity such as a trust, corporation, partnership, etc. Many companies also set a maximum age of an annuitant at 70, 75, 80 or even 85.

Some annuity contracts require the distribution or orderly liquidation of a client's annuity once the annuitant reaches a certain age, typically 80 or 85. A way around this is to name a

coannuitant. If the insurer allows this option, it means that the death of one annuitant will not trigger a possible forced distribution of the annuity.

How is the annuitant role affected by owner-driven or annuitant-driven contracts? Well, if the contract is annuitant-driven, the death of the annuitant may require liquidation of the annuity. In owner-driven contracts, the annuity remains in force if the annuitant dies. The owner must name a new annuitant, or the contract may specify that the owner also becomes the annuitant.

BENEFICIARIES

Beneficiaries of annuity contracts can be a spouse, child, parent, friends, neighbors, relatives, trusts, corporations or partnerships. Most annuity applications also provide for multiple beneficiary designations such as 20% to a son; 80% to a daughter.

Like the beneficiary in a life insurance policy, the annuity beneficiary has no voice in the control or management of the contract. Consider California's **SB 483** that requires that annuities to be disclosed with the State named a beneficiary for the cost of Medicaid assistance with certain specific exceptions. So, if the annuity owner required Medicaid assistance, the proceeds of his private annuity could be used to pay back the state. In cases where the beneficiary does prosper after the death of an annuitant, the beneficiary may have several settlement options: A lump sum, fixed payments for a certain period, payments for life, etc. A surviving spouse beneficiary may have an option to continue the tax deferral of the contract under the spouse continuation rule. This option is not available to individual or named entity beneficiaries.

ROLE OF INSURERS

Insurance companies acquire many obligations and duties in the sale of an annuity. In California, there are also sweeping new mental health and nervous disorder guidelines (**CIC 10127, 10509.6**) that specifically address sales to senior citizens . . . an individual who is 60 years of age or older on the date of purchase. Many of these rules directly affect agents so we will discuss them in some detail:

Advertising (CIC 787)

Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall prominently disclose that an agent may contact the applicant. Further, agents who make contact with a person as a result of acquiring that person's name from a lead generating device shall disclose that fact in the initial contact with the person.

Additionally, no insurer, agent, broker, solicitor, or other person or other entity shall solicit persons age 65 and older in this state for the purchase of annuities through the use of a true or fictitious name which is deceptive or misleading with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement.

What is advertising under the law? **Advertising to seniors includes** envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase an annuity. Advertisements shall not employ words, letters, initials, symbols, or other devices which are so similar to those used by governmental agencies, a nonprofit or charitable

institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public.

Examples of ***misleading advertising*** materials, include, but are not limited to, those which imply any of the following:

- The advertised coverages are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is endorsed by governmental agencies, nonprofit or charitable institutions or senior organizations.
- No advertisement may use the name of a state or political subdivision thereof in a policy name or description.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, or the policy or certificate advertised, or that any agency who may call upon the consumer in response to the advertisement, is connected with a ***governmental agency***, such as the Social Security Administration.
- No advertisement may imply that the reader may lose a right, or privilege, or benefits under federal, state, or local law if he or she fails to respond to the advertisement.
- An insurer, agent, broker, or other entity may not use an address so as to mislead or deceive as to the true identity, location, or licensing status of the insurer, agent, broker, or other entity.
- No insurer may use, in the trade name of its ***insurance*** policy or certificate, any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser.

All advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer shall have written approval of the insurer before they may be used. And, no insurer, agent, broker, or other entity may solicit a particular class by use of advertisements which state or imply that the occupational or other status as members of the class entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

In addition to any other prohibition on untrue, deceptive, or misleading advertisements, no advertisement for an event where insurance products will be offered for sale may use the terms "seminar," "class," "informational meeting," or substantially equivalent terms to characterize the purpose of the public gathering or event unless it adds the words "and insurance sales presentation" immediately following those terms in the same type size and font as those terms.

Free-Look Provisions

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the ***policy cancellation (CIC 786, 10127.10, 10509.6) period*** has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees shall be refunded by the insurer. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest

If a variable annuity is involved, the owner is entitled to a full refund of his account value. And, during the 30-day cancellation period the premium must only be invested in fixed-income investments.

These new rules are underscored by the need for every policy to print, in 12-point bold, the following disclaimers:

YOU HAVE PURCHASED AN ANNUITY CONTRACT. 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 THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY KNOWN AS A SURRENDER CHARGE.

For **variable annuity** contracts, the disclaimer is slightly modified as follows:

THE 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 OR 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 THE 30-DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE.

The free look provisions do not apply to contracts sold through group plans.

Product Specific Illustrations (CIC 1725.5, 10127.11)

Illustrations that accompany annuity contract sales to seniors must now include the following disclosure in bold and set apart from other lines with a 1/2 inch spacing:

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.

Replacement (CIC 10509.6)

Every insurer that uses an agent in an annuity sale must, as part of each completed application, require a statement signed by the agent as to whether he or she knows replacement is or may be involved in the transaction.

Where a replacement is involved, the insurance must:

- (1) Require from the agent with the application for life **insurance** or annuity: (i) a list of all of the applicant's existing life **insurance** or annuity to be replaced, and (ii) a copy of the replacement notice must be provided the applicant. An existing annuity shall be identified by name of insurer, insured, and contract number. If a number has not been assigned by the existing insurer, alternative identification, such as an application or receipt number shall be listed.
- (2) Send to each existing insurer a written communication advising of the replacement or proposed replacement and the identification information obtained pursuant to this section and a policy summary, contract summary, or ledger statement containing policy data on the proposed life **insurance** or annuity. Cost indices and equivalent level annual dividend figures need not be included in the policy summary or ledger statement. This written communication shall be made within three working days of the date the application is received in the replacing insurer's home or regional office, or the date the proposed policy or contract is issued, whichever is sooner.
- (3) Every existing insurer or the insurer's agent that undertakes a conservation shall, within 20 days from the date the written communication plus the materials required in subdivisions (1) and (2) are received by the existing insurer, furnish the policyowner with a policy summary for the existing life **insurance** or ledger statement containing policy data on the existing policy or annuity. Information relating to premiums, cash values, death benefits, and dividends, if any, shall be computed from the current policy year of the existing life **insurance**. The policy summary or ledger statement shall include the amount of any outstanding indebtedness, the sum of any dividend accumulations or additions, and may include any other information that is not in violation of any regulation or statute. Cost indices and equivalent level annual dividend figures need not be included. When annuities are involved, the disclosure information shall be that in the contract summary. The replacing insurer may request the existing insurer to furnish it with a copy of the summaries or ledger statement, which shall be within five working days of the receipt of the request. (c) The replacing insurer shall maintain evidence of the "notice regarding replacement," the policy summary, the contract summary, and any ledger statements used, and a replacement register, cross-indexed by replacing agent and existing insurer to be replaced. The existing insurer shall maintain evidence of policy summaries, contract summaries, or ledger statements used in any conservation. Evidence that all requirements were met shall be maintained for at least three years. (d) The replacing insurer shall provide in its policy or in a separate written notice which is delivered with the policy that the applicant has a right to an unconditional refund of all premiums paid which right may be exercised within a period of 30 days commencing from the date of delivery of the policy. In the case of variable annuity contracts, variable life **insurance** contracts, and modified guaranteed contracts, return of the contract during the cancellation period shall entitle the owner to a refund of account value and any policy fee paid for the policy. The account value and policy fee shall be refunded by the insurer to the owner within 30 days from the date that the insurer is notified that the owner has canceled the policy.

Annual Statements

Whenever an insurer provides an annual statement to a senior citizen policyowner of an annuity contract issued after 1/1/95, the insurer shall also provide the current accumulation value and the current cash surrender value.

Surrender Charges

All individual life **insurance** policies and individual annuity contracts for senior citizens that contain a surrender charge period shall either 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 printed on a sticker that is affixed to the cover page or to the policy jacket.

Qualified v. Non-Qualified Annuities

There are many differences between qualified and non-qualified contracts. In a qualified retirement or tax-sheltered plan, a 401(k) or 403(b) for instance, a client is investing **pre-tax dollars**. Withdrawals from the contract are required at a certain age rather than somewhat flexible. In addition, there may be very specific contribution limits that must be followed. All of these factors make investing in annuities through a qualified plans or through IRAs considerably more complex. In support of this, insurers typically accept the role of third party administrators to advise and notify clients on the workings and planning for qualified contracts.

Company Ratings

This is not a course on insurer safety. However, it is important that we discuss the practice of using the rating services. As a point in fact, the prominent rating companies have played a very important role in insurance industry' history. Rating downgrades are watched closely and can significantly affect an insurer's ability to attract and retain business. Even the rumor of a downgrade may precipitate a **run on the bank**, as in the case of Mutual Benefit years ago, and seriously exacerbate an insurer's financial problems.

Some have expressed concerns about the potential **adverse** effect of ratings on particular insurers and consumer confidence in the insurance industry in general. Once the province of only one organization, A.M. Best, a number of new raters emerged during the 1980s. Questions have been raised about the motivations and methods of the raters in light of the recent sensitivity regarding insurers' financial conditions and what some perceive to be a rash of arbitrary downgrades. On the one hand, insurer ratings historically have been criticized for being inflated or overly positive. On the other side, there are concerns that raters, in an effort to regain credibility, have lowered their ratings arbitrarily in reaction to recent declines in the junk bond and real estate markets and the resulting insurer failures and diminished consumer confidence.

These regulators suggest that a more appropriate regulatory role is to improve consumers' **understanding** of the rating process and allow them to decide how to use the information raters provide. This discussion of the rating agencies does not present detailed factual information relating to the structure and activities of the five most prominent rating agencies -- A.M. Best, Standard & Poor's, Moody's, Fitch and Weiss Research. A summary of their rating classifications is shown below. The philosophy, scope, fees, resources, process, methodology and classification scheme of each of these agencies is the subject of another course. Also, there is no information provided on other insurer rating agencies which have not received as much attention as the five agencies listed above. They include Demotech, Thompson Bankwatch, Conning & Company, Thompson & Schupp and/or other organizations that provide financial analysis of insurers but not ratings per se, such as Ward Financial Group.

INSURANCE COMPANY RATING CLASSIFICATIONS

| RATING | AM BEST | S&P | MOODY'S | WEISS | FITCH |
|----------------|---------|------|---------|-------|-------|
| Superior | A++ | AAA | Aaa | A= | AAA |
| Excellent | A | AA+ | Aa1 | A | AA+ |
| | A- | AA | Aa2 | A- | AA |
| Very Good | | AA- | Aa3 | B+ | AA- |
| | B++ | A+ | A1 | B | A+ |
| | B | A | A2 | B- | A |
| Good | | A- | A3 | C+ | A- |
| | B | BBB+ | Baa1 | C | BBB+ |
| | B- | BBB | Baa2 | C- | BBB |
| Fair | | BBB- | Baa3 | D+ | BBB- |
| | C++ | BB+ | Ba1 | D | BB+ |
| | C+ | BB | Ba2 | D- | BB |
| Marginal | | BB- | Ba3 | E+ | BB- |
| | C | B+ | B1 | E | B+ |
| | C- | B | B2 | E- | B |
| Below Standard | | B- | B3 | | B- |
| | D | CCC | Caa | F | CCC+ |
| | E* | CC | Ca | | CCC |
| | F** | C,D | C | | CCC- |

* Under state supervision
liquidation

** In

There are many different ways to develop rules of thumb using rating service information. One approach might be to delineate a "range of acceptability" among specific rating companies. For example, if an agent were ultra conservative, he or she may set a rule that all his chosen companies must be in the top two categories of the four major rating services:

A++ or A+ from A.M. Best
 AAA or AA+ from Standard & Poors
 Aaa or Aa1 from Moody's
 AAA or AA+ form Duff & Phelps

A slightly less rigid approach would establish a minimum rating requirement of NOT lower than the fourth category from any of the major companies:

A- from A.M. Best
 AA- from Standard & Poors
 Aa3 from Moody's
 AA- from Duff & Phelps

Or perhaps, an agent might decide that a company must only meet one or more requirements from three of the four major rating companies. A word of caution is in order regarding ratings. Agents who do not find a company rated must investigate the reason. If the company has not been around long enough to rate, it may be better to avoid doing business unless a reinsurance contract with respectable contract is in force. Or, it may be necessary to ask the insurer or the

rating company is a rating was issued but suppressed from being published. Currently, only Standard & Poors and Duff & Phelps will suppress a rating.

One major rating agency suggests a way to determine if an insurer is running into difficulty is to monitor several ratings. If the ratings vary widely, this should send a signal that there are other factors of concern regarding the insurer. A recent example is United Pacific Life. In 1992 they were rated A-plus by Duff and Phelps, BBB by Standard & Poors and Ba-1 by Moody's.

THE ROLE OF AGENTS

Basic Duties

The selling of annuities is no different from other insurance products in that the agent / broker generally assumes duties normally found in any agency relationship. The primary obligation here is to select a company and product. However, in the case of annuities, clients typically request a certain investment return or product type (variable, fixed, etc). So, your basic duty may expand to include the agent deciding whether the product is available and whether it is suitable for the client (Harnett, Responsibilities of Insurance Agents - 1990). In California, this has notched up even more with the addition of recent legislation designed to highly regulate the sale of annuities to seniors (60 years or older) . . . more on this in later sections.

Regardless of the type of annuity or the age of your client, it is also a clear **legal responsibility** of agents to understand the **difference between two products** that he is attempting to sell (Benton vs Paul Revere Life - 1994). Whether an agent has an affirmative duty to inform a client of that possible gaps in coverage or a liquidity problem resulting from a large annuity investment depends on the relationship of the parties, specific requests of the client and the professional judgement of the agent (Born vs Medico Life Insurance Co - 1988). Once again, the law is saying that there are no excuses for agents not understanding the policies they sell. Further, if the relationship you have with your client goes beyond agent/client contact, you could be liable for any gaps in coverage or suitability problems that might develop.

Agents & Ratings

As an insurance agent, it may unreasonable to expect you to analyze with high accuracy the true financial status of your carriers. After all, if state regulators and the major rating services don't see pending problems, how can you? Well, studies prove that in virtually all cases of failed companies, a direct correlation existed between the failure and financial strength ratings and / or certain benchmarks. Agents and regulators **should have** seen it coming and reacted sooner. The regulators and rating companies who "missed the mark" simply backtracked. They re-invented their procedures and went on with their lives. Agents accused of the same mistake, however, might face a different scenario: loss of major clients and potential litigation. This is particularly acute for annuities since purchases can be substantial in total dollars and represent a large chunk of a client's assets and income.

If you are not concerned with the ethical reasons to practice solvency conduct for your client, consider that you have a legal obligation to "exercise reasonable care, skill and judgment in procuring insurance" (Williams-Berryman Insurance vs Morphis - 1971). What is reasonable care? Well, in Higginbotham & Associates vs Green (1987), the courts clarified: "If for some reason, the agent or broker knew, or should have known, that the insurer was insolvent at the

time of placement, he or she may be liable for the loss". This language is only a steps away from you being responsible for spotting troubled insurers.

Why not start now? Follow the preferred practice of assessing the solvency of potential carriers. Above all, if you discover or confirm something is wrong, the last thing you would want to do is continue promoting the company to clients. If it sounds like we are stating the obvious, take note: During the substantial failure rate of the 1980's, word on the street commonly fingered several prominent insurers as potential problem carriers. However, with higher commission structures and client bonus incentives, these companies had no problem attracting premium business in the hundreds of millions. Agents truly backed the failure and opened themselves and their clients to potential solvency exposures.

Agents can easily be lulled into believing that placing business with an **A-rated** or better company is sufficient to stay out of trouble. Unfortunately, some in the industry are of the opinion that even **well-rated** companies are at risk of failing. If so, your clients and their attorneys may attempt to hold you responsible.

You might be asking what you are supposed to do: After all, if regulators and rating agencies with all their resources can't predict a solvency how can an independent agent or producer be expected to know? Isn't reliance on an authoritative third-party rating agency sufficient due diligence? Perhaps. Maybe not.

History has proven that a high rating is not a guarantee of anything other than the fact that at the time the ratings occurred, a particular company is more solid than another. And, this fact can change rapidly as it did in the late 1980's when even A+ company balance sheets deteriorated within a matter of months. The decline was not just a drop in ratings; for some companies it was a drop to liquidation! Also, rating agencies, as you will soon see, have created complicated systems of classification with many **qualitative** and **quantitative** measurements. This makes a complete explanation of their criteria almost impossible and it is why virtually all rating companies include disclaimers in their analysis. In effect, they are warning you not to rely on their data.

So, we again come full circle to the question of what should an agent do? Well, with our own disclaimer to check with a professional before you do anything, we suggest you explain to clients that a high rating is **not a warranty of future financial condition** for the insurer of your product. In general, a higher rating can mean a lower probability of failure compared to insurers that are not rated as well. Again, however, there are no guarantees. You can advise those clients that the company is licensed in the state to conduct business and that the company and industry-accepted rating services suggest it is in good financial standing; however, you are not a guarantor of its future financial condition.

Here is how a **sample disclosure** might read:

While we are pleased to provide to you and explain the industry ratings of a particular company or alternate insurers, we do not make any independent investigation of a specific company's solvency or financial stability. We do not warrant or guarantee that any insurance company will remain solvent, and we will not be liable to any insurance applicant or insured for the failure or inability of an insurance company to pay claims

Another misconception by agents is that the use of one rating service is sufficient to determine an insurers financial condition. In fact, you would be encouraged to consult the ratings of at

least three services. If the rating of your company by all three is consistent, there is some agreement among the raters on the financial condition of your company. However, if the ratings vary widely, this might be a signal that there are factors for concern. An example might be the troubled United Pacific Life. In 1992 it was rated A+ by Duff and Phelps, BBB by Standard & Poors and Ba-1 by Moody's.

Required Disclosure (CIC 789.8)

Sweeping legislation in California now requires agents selling annuities to disclose specific facts regarding penalties and tax consequences of selling or liquidate existing to buy annuity contracts, e.g., withdrawal penalties for cashing in a bank CD ahead of maturity, etc. In addition, there is a new requirement that clients sign a disclosure form pertaining to the relationship of a client's potential annuity purchase and Medi-Cal eligibility. Both will be discussed in detail in Part IX.

Advertising and Illustrations

In addition to prominently displaying your agent license number on advertisements, illustrations and letterhead / business cards, effective 1/1/05 agents selling annuity contracts are now required to print the word "Insurance" in the same venues (Section 1725.5 CIC). Past abuses leading buyers to believe annuities were pension plans or aggressive investment opportunities are the reason for this new requirement.

Further, illustrations that accompany annuity contract sales to seniors must now include the a disclosure in concerning the inability to predict future interest rates and values of annuity contracts and the illustrations that portray them. See Illustrations above for the exact verbage required.

Replacement

When accepting an application for an annuity contract, you must now sign and have your client sign a statement as to whether a replacement of an existing annuity or life contract is involved. If a replacement is involved, you must get your client to sign, at the time of application, a special disclosure form identifying the replaced annuity with a special statement regarding the potential consequences of a replacement contract. We discuss this further in Part IX.

Free Look Examination Period

Agents should know that clients over age 60, as well as persons younger than 60, who purchase annuities must now be given the right to cancel them within 30 days (786, 10127.9, 10127.10 CIC). This law, which supersedes similar legislation defining seniors as 65 years, applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees shall be refunded by the insurer. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest.

Specimen Policies (Sample Contracts)

An insurance agent should ***never sell*** an important product like an annuity without first obtaining and understanding a specimen policy and outline of coverage from the insurer. One of the most important reasons to ***obtain*** them is the rapid evolution of products, policies and definitions, e.g., What is an “applicant”, “certificate”, “group policy”, etc. Selling without them is like operating a computer without help screens. Do not depend on the insurance company literature or illustrations to give all the information needed to properly evaluate a policy.



PART IV: Contract Provisions

Choices among annuity contracts are numerous and can be quite complex. It is your ethical and legal responsibility to know the difference between various contracts you are selling as well as options that are widely available. Following is a discussion of provisions common to many annuity offerings:

INTEREST RATES & COMPENSATION

Interest rate earnings paid from an annuity are similar to bank CD's. The amount of interest your client receives or is credited depends on how long he is willing to commit his money and what institution (company) he deposits with. Just like banks, some insurance companies simply offer higher rates and different maturities. Also, depending on the contract, interest can be sent to your client or reinvested to earn compound interest.

Insurers will sell annuity contracts with guaranteed yields for as long as 10 years. In replacing a bank CD or money market fund for an annuity with a maturity longer than one year (most are), your client may lose some flexibility. Likewise there can be surrender charges and penalties for those under 59.5 to withdraw funds . . . both reduce potential interest earnings.

To avoid unpleasant surprises, you should read all the fine print on behalf of your client. Is there an interest **floor**? A **ceiling**? Also, if an insurer is quoting a higher rate than anyone else, find out why. Know the base rate and assess any **teaser rate** that be offered. It may sound good in year one, but what will the interest yield be in subsequent years. Are there higher surrender charges associated with the higher interest? It's your responsibility to know.

Other forms of compensation provided by annuity contracts include a share in profits as in variable annuities or indexed annuities. Both include risks that could substantially effect earnings and your clients need to know this. Again, explore with them any interest floor or cap that is in the contract and, if applicable, the possibility of no earnings at all.

ISSUE AGES (CIC 10112)

Annuities can be purchased by just about anyone. Some companies place maximum age limits on owners and/or annuitants -- usually between ages 75 and 90. Younger buyers, under 18, may even possess all legal rights associated with owning contracts as long as they have the written consent of a parent or guardian. Of course, in the case of a minor, any liability resulting from the ownership of the annuity accrues to the parent or guardian.

MAXIMUM AGE FOR BENEFITS

Most companies generally require that annuitants be under the age of 75 when the contract is initially signed. Others allow a range up to age 90. Benefits are triggered when something happens to an annuitant or owner. However, some contracts **require** distribution or an orderly liquidation once the annuitant reaches a certain age, typically 80 or 85.

SURRENDER CHARGE WAIVERS & TRIGGERS

If your client becomes seriously disabled or needs to go to a nursing home, their annuity contract may hopefully contain a waiver that **triggers payments** or withdrawals that are not subject to the usual surrender fees. Serious health changes, such as a chronic long term are illness, may also trigger annuity payments.

Not all annuities permit crisis waivers. In general, they seem to be more common and generous in fixed annuities, rather than variable contracts. And, situations that trigger the waiver and allow your client to make early annuity withdrawals vary from company to company. For instance, one insurer might require a 90-day nursing home confinement before your benefits are activated, while another might call for 60 days. In addition, one company may consider that your client is disabled if you're unable to work in any occupation, while another may require that he be unable to work in your current occupation. (A surgeon, for instance, may be deemed disabled by one insurer if he or she cannot operate because of, say, arthritis in the hands. Yet another company might decide that the doctor can still see patients in an office setting, without performing surgery.)

NOTE: California requires individual annuity contracts for seniors to contain a disclosure regarding the surrender charge period unless the contract does not contain those charges. These disclosures should be printed in 12-point bold text.

Death Waiver

This waiver passes on the full account value of the annuity to a beneficiary if the owner dies before annuitizing; that is, before you begin to receive payments from your annuity, presumably at retirement.

Example: Variable annuity owner John dies. The fund value as of the date proof of death is received; the total of all payments made into the annuity less withdrawals and related withdrawal charges; or the highest contract fund value, as calculated every third year on your contract anniversary date (adjusted for withdrawals he made). Annuity contributions remain unchanged even if your subaccounts have lost value. The beneficiary is responsible for taxes on the gain in your contract.

Nursing Home Waiver

When your client's contract includes a nursing home waiver, he won't be charged surrender fees and will be allowed access to some or all of his annuity if he is confined to a nursing facility.

Contracts may require a certain confinement period (usually 90 days) before withdrawals and there may be limitations on the type of care you are receiving before funds are released.

Example: Marge and John's annuity includes a nursing home waiver. However, the contract imposes a 180-day confinement period to a "licensed nursing facility" before penalty free withdrawals are allowed. In addition, a doctor must submit an attending physician's statement, along with a completed claim form. In essence, this insurer wants to be certain of their incapacitation. Insurers may additionally require that their own doctor examine your client before allow a waiver of penalties.

Terminal Illness Waiver

An annuity might contain a provision that waives surrender charges if the annuitant/owner becomes terminally ill, thus allowing access to money when it is needed most. While the definition of terminally ill may vary slightly from company to company, it's generally a condition that will result in your death within six months to a year. One annuity, for instance, defines a terminal illness as "an incurable condition that, with medical certainty, will result in death within one year."

As with the nursing home waiver, an insurance company may want certification from a doctor, and perhaps from their doctor as well, that the life expectancy is indeed only a matter of months.

Unemployment Waiver

Unemployment waivers are very rare. One that we know of, allows your client to withdraw from its contract if he is unemployed for more than 30 days.

Disability Waiver

The risk of disability is greater than the risk of death at all ages between 20 and 65. That said, it makes sense to protect your clients financially if they become disabled, and that includes annuity considerations. Unfortunately, relatively few insurers offer a disability waiver.

Where these waivers exist few will purposefully leave the definition of "disability" fluid. Some may state that if the owner/annuitant is unable to work, and thus can't earn a living, and a doctor attests to this, they will allow full access to the annuity without imposing surrender charges. This is a more liberal interpretation. More than likely, definition of disability will be considerably more stringent.

Charges and Fees

In most cases, there's no extra charge for waivers because they're built into the contract when purchased. There are, however, certain tax consequences that could apply to such withdrawals. It is always best to advise your client check with a tax advisor before taking money out of their contract.

PREMIUM PAYMENTS (CIC 10540)

Premiums for annuities are usually paid in one of three ways:

- 1) In the first method, the customer pays a single, lump sum premium when the contract is signed. For example, an individual may purchase an annuity with a single payment of \$10,000, \$50,000, or any other minimum amount that the insurance company will accept. Lump sum premiums can be paid for either immediate annuities or deferred annuities.
- 2) The second method is available only for deferred annuities. In this option, the customer pays premiums on a regular schedule (annual, semiannual, quarterly or monthly) until the date on which benefit payments begin. Some individuals choose this option because it is similar to making regular deposits in a savings account -- a comfortable, familiar habit.

3) The third option, is the flexible premium annuity. This feature permits flexibility in the timing and amount of premium payments. The flexible premium annuity often is attractive to individuals who want a program in which they can vary the amounts they save each year. People who earn commissions or other types of irregular income and families with growing children are two examples of customers who may be interested in a product with this type of flexibility. For example, contract terms of a typical flexible premium annuity may require an initial minimum deposit of \$2,500. If the contract remains in effect, the funds that already have been paid in will continue to accrue interest, even if the annuity owner does not wish to pay into the annuity on a regular schedule. Most variable annuities are flexible premium contracts.

Note: An incorporated life insurer issuing life insurance policies on the reserve basis may collect premiums in advance. Such insurers may also accept moneys for the payment of future premiums related to any policies issued by it. No such insurer may accept such moneys in an amount to exceed (1) the sum of future unpaid premiums on any such policy or (2) the sum of 10 such future unpaid annual premiums on any such policy if such sum is less than the sum of future unpaid premiums on any such policy. This section shall not limit the right of such insurers to accept funds under an agreement which provides for an accumulation of such funds for the purpose of purchasing annuities at future dates.

SETTLEMENT OPTIONS

Settlement options refer to the various ways that funds from an annuity will be distributed. The insurance company and the annuity owner agree to settlement terms when the owner wishes to begin receiving income from the annuity. It is important to note that once an annuity contract is settled, the owner loses the right to make withdrawals beyond the scheduled payments, and the right to surrender the contract.

Four major types of settlement options are commonly available.

Single Lump Sum

The settlement may be made in a single lump sum. This lump sum includes both the amount the owner paid in premiums and the interest the funds have earned.

Interest-Only Payments

The owner may decide to receive interest-only payments until a later date on which another settlement option will take effect.

Designated Dollar Amount

The owner may elect to have the settlement paid in a specified number or designated dollar amount of payments over a number of years. For example, the annuitant could receive quarterly checks for equal amounts over a 10-year period.

Life Income Option

The life income option is perhaps the one most commonly associated with annuities. With the life option, the annuitant receives payments until he or she dies. Payments may or may not continue after the annuitant's death. Three life income options are straight life, period certain and refund.

Straight Life

A straight life annuity contract provides for guaranteed periodic payments that terminate upon the annuitant's death. No remaining balance is paid to a beneficiary or to the annuitant's estate after the annuitant dies.

To understand how a straight life annuity works, consider the case of Lee Smith, who several years ago purchased a straight life deferred annuity that would begin providing him with a regular income when he reached age 65. Lee lived until age 87 and received annuity payments until his death. Once he died, payments ceased. Had he died at age 67, the insurance company that had sold him the annuity would have stopped payments at that time. Had he lived to age 100 or more, the company would have made payments to him until then. The straight life annuity option, therefore, does not guarantee that the annuitant will receive payments equal to the amount paid as premiums on the contract. (In the event of the contract owner's death during the accumulation period, the proceeds will revert to the beneficiary. If no beneficiary has been named, proceeds will revert to the annuitant's estate.) Because this option limits potential payouts, insurance companies offer a higher return for it than for some other plans, such as those described next. Overall, the straight life annuity option provides the maximum income per dollar of outlay compared to other annuity options.

Period Certain and Refund Options

Some individuals do not want to use the duration of their lives as the factor that determines whether they will profit, break even or perhaps even lose money on their investments. Straight life annuities, therefore, do not appeal to them. Instead, these individuals often choose annuities with period certain or refund options. Period certain and refund options guarantee a minimum amount that the insurance company will pay on an annuity. Both of these options can be regarded as types of death benefits, since they provide for a payment to be made to designated beneficiaries upon the annuitant's death. Because they provide added benefits for the consumer and create additional costs for the insurance company, annuities with period certain and refund options offer the consumer lower per premium dollars than do straight life annuities.

Period Certain

Period certain refers to a guarantee from the insurance company that it will make annuity payments to a beneficiary for a specific number of years, even if the annuitant dies before the end of this period. However, payments to the annuitant will continue as long as he or she lives.

Since a period certain option of a fixed annuity may be selected at the same time that other settlement agreements (such as the amount and frequency of payments) are determined, it guarantees that a specific sum will be paid out by the company. For example, consider a life annuity with a five-year period certain option. If the annuitant dies during the third year of the liquidation period, the insurance company will continue to make payments to the annuitant's beneficiary for the next two years. If the annuity pays out \$4,000 each quarter (\$16,000 a year), a five-year period certain guarantees that \$80,000 will actually be paid out. (It is common for insurance companies to pay the present value of the remaining payments in a lump sum to the beneficiary rather than continuing the payments until the end of the certain period.) If the annuitant survives the first five years of the liquidation period, the annuity will continue to be paid out in the normal manner, ceasing upon the annuitant's death.

Refund Option

The refund option is another form of guarantee offered by insurance companies. This option provides that in the event of the annuitant's death, the company will pay out an amount at least equal to the total dollars paid in as premiums. Since this is another form of life income option, the company will, of course, continue to pay the guaranteed amount of monthly income for as long as the annuitant lives.

Refund options can be classified into two basic types. With a cash refund, the insurance company agrees that if the annuitant dies, it will refund, in cash, the difference between the income that annuitant received and the amount paid in premiums, plus interest earned. With an installment refund, the insurance company agrees to continue to make periodic payments to the annuitant's beneficiary until the total of the payments made to the annuitant and to the beneficiary equals the amount the owner paid for the annuity contract, plus interest earned. The longer the payout is to continue after the annuitant's death, the smaller the periodic payments will be. Refund and period certain options offer benefits to a consumer who is reluctant to invest a substantial amount of money in a product whose return depends solely on the length of his or her life. At the same time, not all annuity purchasers favor refund options. The main reason is money; annuities with refund options pay annuitants lower amounts of income than do comparable contracts without them. The refund option represents an extra benefit for the contract owner and an extra cost for the insurance company.

Non-Qualified Plans

Once a nonqualified annuity under a settlement plan, each payment is considered part nontaxable and part taxable income. This is because the initial purchase payment and any additional contributions you made were with after-tax money. An exclusion ratio is determined for each payment which then determines the amount of each payment to be excluded from taxes.

In addition to any income tax, there is a potential federal penalty for annuity withdrawals for investors under age 59.5. This 10% penalty (IRS Section 72q) was designed to discourage investors from withdrawing early from nonqualified annuities. However, should your client choose the option to settle his contract either on a lifetime or two lifetimes, before age 59 1/2, withdrawals qualify as an exception to the penalty rule and will **not** be subject to the additional 10% tax. Those who are planning for early retirement may find this option advantageous.

Tax Qualified Plans

For qualified annuities (purchased through a qualified plan such as a 401(k)), the initial premium, any additional contributions and interest earnings were all untaxed. Therefore, 100% of each payment received through any settlement plan will be considered taxable income.

Surrender Charges (CIC 10127.10, 10127.12, 10127.13)

Most annuities levy a surrender charge (from 0 to 8%) for any withdrawals that exceed the free withdrawal (discussed below) privilege (typically 10%). The surrender charge usually fades away in time (0 to 10 years). If your client withdraws money from a variable annuity within a certain period after a purchase payment, he will also incur a surrender charge. It is important to advise clients that this charge could effect the value of his account and reduce overall earning potential.

Example: Mark's annuity contract specifies a 6-5-4-3-2-1-0 surrender penalty structure. This means that the company's withdrawal or surrender penalty lasts for six years. The first year penalty is 6%, then 5% in the second year; 4% in year 3 and so on. After six years, there is no penalty to withdraw or surrender. Also, Mark may have the option to take free withdrawals along the way as long as the amount taken out does not exceed the 10% free withdrawal limit.

Example: Ellen purchased a variable annuity contract with a \$10,000 purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, she is allowed to withdraw 10% of your contract value each year free of surrender charges. In the first year, she decides to withdraw \$5,000, or one-half of your contract value of \$10,000 (assuming that your contract value has not increased or decreased because of investment performance). In this case, she could withdraw \$1,000 (10% of contract value) free of surrender charges, but she would pay a surrender charge of 7%, or \$280, on the other \$4,000 withdrawn. Ellen's overall earnings are reduced by \$280 -- a reduction that might not occur in other investment mediums.

Market Value Adjustment

In periods of rapidly dropping or rising interest rates, insurers have developed a new tool to adjust yields -- the market rate adjustment (MVA). Simply put, the MVA will increase or decrease the surrender penalty, depending on market rates at surrender compared to the contract period guarantee rate. In other words, the MVA is a separate and additional adjustment made at the time of an early surrender that can be either negative or positive for your client. It all depends if interest rates have increased or decreased at the time your client wants to withdraw his money. The MVA does not typically apply to the free withdrawal portion or surrenders taken after the death of an annuitant.

Market rate adjustments can be very complex. Some are expressed as a factor or percentage rate adjustment tied to a certain block of securities owned by the insurer. If your client decides to withdraw funds from his annuity at a time when market rates have risen, the insure will lose money when selling his securities and need to charge your client a higher penalty. If rates have dropped, there will be less MVA penalty.

Example: The value of Frank's annuity is \$50,000. In the current year, his surrender charge is 6% or \$3,000. However, since Frank purchased his annuity **market interest rates have risen** and his insurer indicates a MAV adjustment of \$1,500 is necessary to offset the loss they will incur when they sell certain securities to return Frank's money. So, Frank's current surrender value is calculated as follows: \$50,000, less \$3,000 surrender charge, **less** \$1,500 MVA adjustment for a net surrender value of \$45,500.

Example: Sally needs to withdraw her \$50,000 annuity with a current surrender charge of 6% or 3,000. Since Sally purchased this annuity, **interest rates have dropped** so her insurer has indicated that her MVA will actually soften her total surrender charges. Sally's current surrender value is calculated as follows: \$50,000, less \$3,000 surrender charge, **plus** \$1,800 MVA adjustment for a net surrender value of \$48,800.

Senior Citizens and Surrender Charges

There are a few exceptions to the collection of surrender charges where senior citizens (over age 65) are concerned:

- Surrender charges cannot be levied if a client **cancel**s his annuity contract **within the 30-day** free look period.
- Whenever an insurer provides an **annual statement** to a senior citizen for his individual annuity contract issued after January 1, 1995, the insurer shall also provide the current accumulation value and the current cash surrender value, i.e., the surrender charges are disclosed.
- All annuity contracts for senior citizens that contain a surrender charge period shall either 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 printed on a sticker that is affixed to the cover page or to the policy jacket.

POLICY ADMINISTRATION CHARGES AND FEES

Not all the money a contract owner pays into an annuity are invested, since some are used for sales commissions and fees. These charges differ among companies and among contracts. Some companies (mostly fixed annuity plans) have no charges other than the surrender fees discussed in the last section. In the event the insured dies, for instance, they guarantee to pay the beneficiary **at least** the amount paid in to the contract, regardless of the current cash value of the contract.

Variable contracts are quite different. Each typically has its own schedule of fees and other charges, and the investor should carefully assess these before making a purchase. These can include annual contract charges, management fees and mortality charges.

WITHDRAWAL OPTIONS

Most annuities allow withdrawals of up to 10 and percent per year after an initial waiting period of one year, without cost, fee or penalty. The **free withdrawal** is typically based on a percentage of principal, not the current value. However, some companies calculate the penalty free withdrawal on the greater of the current value or principal contributed.

Example: Mary invests \$50,000 in an annuity and later adds another 25,000. In a few short years, her account grows to \$100,000. Mary suddenly needs funds to pay for nursing home costs she has occurred. The maximum she can withdraw from most companies is \$7,500 or 10% of her principal invested. More liberal companies might allow her to take out \$10,000 or 10% of her current account value.

Some companies also let you take out **all** of your account growth (accumulated interest) at any time without a fee or penalty. Others levy penalties only during a prescribed period of time . . . the first five or seven years.

Example: Bill has owns a \$250,000 annuity. His account is now worth \$350,000. His insurer allows free annual withdrawals up to 10 percent based on the value of his **original contribution** or \$25,000 per year and/or up to his annual earnings without penalty. If Bill needs it, he can take a \$100,000 free withdrawal.

A few companies also permit cumulative withdrawals. So, if your client hasn't needed to withdraw any funds, the amount he has not taken out accumulates to his credit.

Example: Susan's \$100,000 annuity permits cumulative 10% annual free withdrawals -- \$10,000 per year. It's been three years since Susan has owned her contract and she has not withdrawn a single dollar. A health care emergency requires additional cash. Her insurer allows her to take \$30,000 from her account without penalty.

Note: Free withdrawals are a nice feature but it is not something that should completely **drive** your decision to recommend a particular annuity. Why? Because, a majority of people who own annuities never use their free withdrawal option and the restrictions on withdrawals typically fade away in a matter of years.

ANNUITIZATION OPTIONS

The annuity is an investment vehicle often used for retirement. These days, however, people are concerned more than ever about outliving their retirement nest egg. Many insurers respond to this with an array of annuitization options that can provide a stream of income for a specified period of years or for life!

When a client chooses to annuitize, the insurance company will turn their principle into a monthly, quarterly, semiannual, or annual income. Once a decision is made there is typically no turning back, although some new plans allow a client to stop receiving payments and take the remainder in a lump sum.

There are several ways to receive annuity income payments:

A **straight life annuity** provides income until the annuitant dies.

An **annuity certain annuity** provides income for a fixed period of time, such as 10 or 20 years.

A **variable life annuity** provides variable income during the annuitant's lifetime.

A **variable life with period certain annuity** provides variable income during the annuitant's lifetime. If the annuitant dies before the designated certain period, the insurer will pay the contingent payee you have selected.

A **life income with refund annuity** provides income throughout the life of the annuitant. If the annuitant dies before receiving payments at least equal to the purchase price of the annuity, the insurer will pay a refund to the contingent payee you have selected.

A **life annuity with period certain annuity** provides income until the annuitant dies. If the annuitant dies before the designated certain period, the insurer will pay the balance to contingent payee you have selected.

A **joint and survivor annuity** provides income to two or more individuals until all of the individuals die. Some contracts might reduce the amount paid to the surviving spouse after the death of the first spouse.

Other annuity income options include a lump sum payout or systematic distributions.
Which type of annuity is right for me?

Who would annuitize? Someone who wants out of his annuity without incurring a surrender charge. A widow or widower with no kids may care more about living comfortable doing their retirement years than skimming off their retirement and possibly outliving their money. Another strategy is to buy enough life insurance to cover the loss of the income from your death then elect the highest annuity payout without the fear of leaving a spouse broke.

In analyzing the decision to annuitize it is important to consider the following:

- In a fixed rate contract, the interest rate assigned to the payout will be frozen. There will be no adjustment for inflation or growth.
- The annuitization period will dramatically effect the payout amount. A \$100,000 contract annuitized over five years will produce a much higher payment than one over 10 years. It also follows that a lifetime payout will be even less.

FIXED ANNUITY CONTRACTS

A fixed-rate annuity is a contract between a policyowner and an insurer that requires a policyowner to pay either a lump sum or periodic payments to the insurer to establish the principal, from which the insurer guarantees the policyowner a fixed or promised rate of return. The insurer allocates all of the principal invested by the policyowner to a general account, and, in return, makes guaranteed periodic payments to the annuitant out of the insurer's earnings from its investment portfolio held in the general account.

In a **fixed-rate annuity**, the cash value accumulation (or the annuity income) is a stated dollar amount that is guaranteed by the insurance company and on which (or with respect to the annuity income) the insurer pays a specified or determinable rate of interest. In effect, it is a fixed-dollar, guaranteed-principal kind of investment medium that is in some ways analogous to CDs. The **investment authority and investment risk** are on the insurance company because it is the insurer that guarantees the cash value (or annuity income) and specifies the interest rate currently being paid on cash value accumulations.

Consequently, unlike variable annuities, fixed-rate annuities have little or no investment risk, because the payout is guaranteed by the insurer/issuer as part of its general account obligations. It is this reason that prompts many insurers and agents alike to compare them to CD's and even name them similarly as CD Annuities. Be advised, however, while they sometimes offer better rates and helpful tax advantages, they are also much harder to get out of, and they are not protected by the Federal Deposit Insurance Corp. Some experts advise against CD-type annuities because of the interest costs and IRS penalties involved in getting out. If rates go up, you're locked in at a lower rate.

Some CD-type annuities are different from other fixed annuities in that the guaranteed rate matches the penalty period. In other words, if you buy a five-year CD-type annuity at 4 percent, you're guaranteed to get 4 percent annually if you hold the CD for five years.

Other fixed rate annuities have no maturity date and often guarantee a rate only for the first year. The interest rate usually drops after the guaranteed period and is adjusted annually. Those annuities tend to have a bad reputation, even among people in the insurance industry -- the only people licensed to sell annuities.

The bottom line with fixed annuities is that tax-deferred earnings or a promise of an income you can't outlive are attractive features to many investors. Other issues to examine, however, include long-term risk, current liquidity, effective earnings (after penalties and bonus interest) and taxes down the road.

Death Benefits

Principal in a fixed-rate annuity contract is guaranteed everyday. This means that the beneficiary receives the greater of the principal or the value of the account as of the date of the annuitant's death. Beneficiaries may also have options as to how they receive a death benefit, e.g., ***a lump sum or over a period of years***. Accepting a five-year pay, for example, out can ease taxes slightly and result in a larger balance due to accumulated interest paid by the insurer. Typical death benefit provisions might last until the contract is terminated, annuitized or the annuitant reaches the age of annuitization . . . anywhere from 75 to 85.

Charges and Fees

Other than surrender charges (discussed above), most fixed-rate annuities have no associated fees or charges. Some have minimal annual contract fees of \$30 or so. And, in low interest rate markets, even these must be considered in calculating overall yield.

Interest Rates

Fixed rate contracts may offer a set return for specified period of time. The rate can be ***guaranteed*** for this period or simply ***promised***. And rates can also vary widely between companies and products for a variety of reasons. Choosing a suitable rate means uncovering the length of time invested, the promised rate of interest, the guaranteed rate of interest as well as consideration for potential surrender charges if an early withdrawal is required. Many companies offer a first year bonus or teaser rate which can drop considerably in the subsequent years. In some cases, the only way to keep the bonus is to annuitize the contract. Further, a fair amount of companies are now applying market rate adjustments to any potential surrenders (see above) to reflect current market conditions. In other words, while it is important to assess the ***annual*** rate of interest credited, it is more likely that a ***multi-year*** strategy must be adopted to analyze the effective return of any fixed annuity. The longer the term, the more easily a surrender or MVA charge can be absorbed.

Example: Dave is considering an \$100,000 annuity contract offering a current base rate of 5% with an additional 2% bonus in the first year but it will only apply if the client annuitizes his payout. Surrender penalties are 5-4-3-2-1-0 expire at the end of five years with a market value adjustment in place. The minimum guaranteed interest rate is 3%. As an ethical agent you need to point out to Dave that the rate of 5% is not promised and it is likely to be lower in subsequent years. Also, the 2% first year bonus will be lost unless Dave agrees to receive his money back over a period of years (typically 5 years). Finally, if Dave needs his money sooner and rates in the market have risen, it is likely that he will pay the applicable surrender charge plus additional penalties in the form of a MVA adjustment.

Crediting of Interest

When selling annuities, it is extremely important that you correctly explain to the buyer how the contract is designed to work. Companies today are more likely to credit interest quarterly,

monthly or even daily. This allows insurers to be more competitive and react quicker to interest rate fluctuations in the market. Insurers are also using market rate adjustments (discussed above) to negatively or positively adjust a client's surrender charge where early withdrawal of funds is desired. Both factors eventually effect your client's yield.

What is critical to understand about any annuity interest rate is whether it is **guaranteed** or just **promised**. Some companies offer a higher rate but only “promise” to continue paying it. For example, a company may offer a **base rate** or **first-year bonus teaser rate** that appears to increase the overall yield. Always look for how long it is offered (one years two years, etc) and what it resets to after it expires. Bonus annuities can “guarantee” to offer a minimum, however, the **annualized interest rate calculation** (average yield to maturity) may not be known at the time of purchase because the rate can fluctuate after any fixed bonus expires. Also, be aware that really great sounding rates are typically offset by higher and longer surrender charges. The crediting of annuity interest rates is also effected by the nature of the product and company. Here are some basic designs to understand:

Portfolio Rate Annuities

These contracts offer a guaranteed interest rate for an initial period of time, such as one, three or five years. After the initial rate period, renewal rates are based on the earnings of the underlying investment portfolio. In other words, all policyowners are lumped in a single group and given the same rate. When market rates are declining in the market, the portfolio type of contract would seem to be advantageous.

Banded or New Money Annuities

The banding approach will segregate different bands of contracts and assign different rates to each. Older contract monies might be earning one rate of interest, while newer contracts earn another. When interest rates are rising in the market, a new money plan would seem to be more advantageous.

CD-Type Annuities

These work basically the same as bank CDs in that the company will typically guarantee a rate for a given period of time. At the end of the guarantee period, the policyowner may surrender the annuity for its full value, transfer the full value to another annuity or renew for a new period of time. Of course, early withdrawal penalties may apply.

Two Tier Annuities

This type of product are the most difficult to explain and in some cases downright misleading. These plans may offer a large, up front bonus on top of the normal interest rate. However, the bonus may be forfeited unless the contract owner annuitizes. Or, a two-tier plan may credit the contract with a lower rate of interest if a partial or total liquidation is made. These plans often have much higher surrender charges . . . some never disappear. Interest crediting may also be lower if the owner chooses a minimum payout plan, e.g., choosing to annuitize over three years instead of five years. Rates during annuitization may also be artificially low to offset seemingly higher rates during accumulation.

Minimum Guaranteed Interest (CIC10168.25)

Beginning January 1, 2006, the state of California, new legislation (AB 284) regarding minimum guaranteed interest for fixed annuities. The primary goal of the law's revision is to provide a means to permit lower interest rate guarantees than the current law allows in low interest rate environments. Legislators agreed on a cap equal to the **existing three percent** interest rate. However, in order to provide some minimum level of guarantee to the consumer, a **floor of one percent** was also established. Finally, flexibility was provided to the companies by allowing for the re-determination of the minimum interest guarantees on a periodic basis by using the five-year Constant Maturity Treasury Rate, less 125 basis points

AB 284 also significantly reduces the maximum expense loads that may be charged by an insurer by limiting annual contract fees to \$50. This bill, however, is **does not** affect any contract now in effect.

The passing of this bill is a strong indication that the current low interest rate markets are having an impact. Annuities are one of the few savings products that offer guaranteed lifetime income, ensuring that a person will not outlive their assets. Extremely **low rates** have had negative effects on the ability to accomplish.

VARIABLE ANNUITY CONTRACTS

To understand the structure of the variable annuity, we must compare it to the fixed annuity. Like the fixed annuity, the variable annuity is a contract between an individual and a life insurance company. With both types, the owner contributes premiums that, along with their earnings, are accumulated within the policy contract. At an agreed-upon time, the insurance company begins making payments to the annuitant. Payments are made over the individual's lifetime or for some other stipulated period.

In general, insurance companies invest funds for their fixed products in long-term bonds and other non-speculative issues. In contrast, the premium payments made on a variable annuity are not combined with the insurance company's general investments; instead, they are placed in stocks, government securities and other types of fluctuating investments. These investments have more growth potential than those that underlie other investments, but they are also subject to a greater degree of risk. The investments make up a portfolio that is managed in much the same way as a typical mutual fund. For many years, marketers of annuity products, along with savings institutions, emphasized the advantages of conservative and secure investments.

Then, rising inflation rates began to affect the average person's standard of living. Beginning in the 1960s, people became aware that they had to plan for more retirement dollars just to keep pace with anticipated increases in living costs. Savers sought financial instruments that could more readily keep up with inflation. Individuals of even average means were turning to the stock market for an increasing portion of their investments. Like savings institutions, insurance companies looked for ways to improve their traditional products. In an attempt to combine traditional annuity guarantees with the growth potential of a securities investment, they developed the variable annuity. The prospectus will warn potential investors against all of these issues.

Prospectus

Variable annuities are sold by prospectus **only**. Some fixed annuities, where interest rates are tied to market indexes, also require a prospectus. Most, however, are guided by the terms in the policy which can be reviewed through a specimen or sample policy. The prospectus will show how accumulated funds are invested and the resulting payout and warn potential investors on issues such as inflation, loss of investment, loss of liquidity, etc. For example, during the 1930s, when U.S. economy was experiencing only moderate inflation rates, many people purchased annuities for retirement, in the belief that they ensured a comfortable, guaranteed income for life. A successful insurance company advertisement of the late 1930s enthusiastically proclaimed, "Retire for life on \$300 a month!" Such a claim would require many disclosures if sold by prospectus.

Common Contract Provisions

Variable annuities come in many different flavors. One difference lies in who has control over investing the money deposited into the annuity. With **general accounts**, the insurance company determines how the annuity funds are invested. Others, use **separate accounts** which allow the annuity owner to have substantial control over the investment of funds.

One should be aware that the marketing of variable annuities by some sellers deserves scrutiny, especially when seniors are the targeted investors. The **Financial Industry Regulatory Authority (FINRA)** helps play a role here as an independent regulator to help identify high-risk firms, brokers and products. When rules are broken, they bring discipline to bear by barring FINRA membership or issuing fines. FINRA also offers tools and help to investors assess security-oriented investments such as variable annuities.

Company-Managed Variable Annuity

The insurance companies' investment managers buy and sell these investments on a continuing basis. Like mutual fund managers, the insurance company tries to invest the money wisely and profitably so that it will generate a competitive return for its investors. In addition, the insurance company must meet both state and federal regulations regarding investment practices for these products. (Variable annuities are subject to regulation by the Securities and Exchange Commission, Internal Revenue Service and state regulatory bodies.)

One of the better-known company-managed variable annuities is the College Retirement and Equities Fund, or CREF. Designed by the Teachers Annuity and Insurance Association, it was the first variable annuity, appearing on the market in 1952. Because of CREF's relatively long history, it has been the subject of many detailed studies.

For an example of a hypothetical company-managed variable annuity, see Illustration 1 at the back of this book. The investment portfolio for this annuity consists of a combination of stock, bonds and money market instruments.

Note that at different times, the insurance company's investment managers varied the mix of investments based on the perceived market potential for each type of investment used in the plan. For example, on December 31, 1992, the mix was 37 percent stocks, 18 percent bonds and 45 percent money market instruments. The fund managers decided that by June 30, 1993, they would sell all the stocks and switch to bonds (63 percent) and money market instruments (37 percent). By the concluding period, the fund consisted of a fairly balanced mix of 39 percent stocks, 36 percent bonds and 25 percent money market instruments. The above sequence of

investment decisions demonstrates the continuous management of assets placed in variable annuity funds.

Investment managers consider various economic indicators in making decisions that they believe are timely and will lead to maximum profits.

Self-Directed Variable Annuity

With the self-directed variable annuity, the contract owner can choose from several investments . . . **subaccounts** . . . each with different goals. This allows an investor to diversify his holdings and select investments based on his or her objectives in much the same manner that a mutual fund investor does. Following are some typical choices:

Equity-Based: Funds are invested in steadily growing, strong companies with a history of growth potential. The goal is long-term growth.

Risk-Based: Exposure to companies on the cutting edge of innovation. The goal is to capture significant investment opportunities with the potential for greater price volatility (more risk).

Fixed Options: The fixed portion of a variable annuity emulates the fixed annuity. So, anytime an investor has had enough of choices or decides its time to move from equity- or risked-based position, he can move his funds here.

In effect, the contract owner may construct a personal investment portfolio within the annuity and his selection of investments can generally be made during both the accumulation and distribution periods.

Senior Citizen Considerations (CIC 10127.10)

In California, a senior citizen investor (age 60 and above) in variable contracts receives special consideration during the 30-day free look period. During this 30-days, the premium for a variable annuity may be invested only in fixed-income investments and money-market funds. This assures that upon a cancellation of the contract the owner will be refunded **all** premiums in full, as though the contract was never purchased.

Where the senior investor has specified his funds immediately invested in mutual funds, a cancellation will entitle him to a refund of the account value within 30 days.

Choosing an Annuity Investment Portfolio

The annuity application form lists the selection of investments that the insurance company offers. Based on his investment objectives, the customer indicates, usually in percentage units, how each premium is to be allocated among the selected accounts. Most contracts allow an unlimited number of percentage combinations. The applicant can even allocate the entire premium to a single investment choice.

A typical offering might include four mutual funds with differing objectives, plus a fixed account. The fixed account offers guaranteed safety of principal and specifies a fixed interest rate. (Interest rates on the fixed account may be guaranteed for periods ranging from one calendar quarter to one or two years or even longer.)

Changing the Investment Mix

One distinguishing characteristic of self-directed annuities is the owner's ability to change the composition of the annuity portfolio. Three major factors that affect how individuals invest their assets are their investment objectives and philosophies, and their financial standing and economic conditions. Since each of these factors may change over time, it is advantageous to the investor to be able to change the way in which his or her money is invested.

As an individual progresses through life, his or her investment philosophy and objectives often change. Many people who previously might have been inclined to take investment risks may become more cautious as they grow older. For the owner of a variable annuity, a change to more conservative investments may mean moving money from stock funds to funds composed of government securities or even a fixed fund. The typical self-directed variable annuity offers the contract owner the opportunity to redirect the investment of funds as his or her investment objectives change.

The owner may also make transfers to and from a fixed account. IN some cases this is done through an 800 number, via internet or through a stock broker.(Note, however, that transfers from the funds to the fixed account, or the reverse, are more limited than transfers among the funds.) These rules provide ample opportunity for changes in investment directions.

Changes in one's financial standing may also alter an individual's willingness to accept risks. For example, some individuals may invest in more aggressive and risky funds only after they have accumulated what they consider an adequate nest egg. Similarly, some individuals move their variable annuity funds into conservative options if they experience losses in their other investments.

Economic conditions and forecasts may also lead an individual to take advantage of a variable annuity's flexibility. When stock prices are expected to fall, some individuals direct their money out of stock funds and into other types of funds. When yields on other investments are falling, investors often move their money into bond funds because these generally are considered good investments during such periods. Thus, variable annuities allow the investor to react in the face of changing market conditions.

Examples of Self-Directed Plans

To better understand the implications of investment choices in a self-directed plan, look at some hypothetical investors and their choices of investment mixes from the options outlined on Illustration 2.

Young Executive: Ruth is a 25-year-old upwardly mobile executive. Her preferred investment mix looks something like this: 60 percent Emerging Growth Fund; 40 percent Growth Stock Fund. Ruth figures that she can invest in these rather speculative funds because if she makes some incorrect decisions and sustains some losses, she has plenty of remaining years in which to deposit additional funds and still accumulate an ample nest egg. Also, as Ruth grows older, she may become more conservative with her investment choices and less inclined to speculate.

Empty Nester: Charlie, age 55, is a university professor. He chooses an investment mix as follows: 50 percent Financial Bond Fund; 40 percent Cash Management; 10 percent Growth Stock Fund. Charlie's rationale for these relatively conservative choices is that he wants to be on the safe side -that is, accumulate as much as possible and expose only a small portion of his

investment to risk. Perhaps, at an earlier age, he would have indulged in greater speculation, but now it seems wiser to be more conservative.

Retiree: Frank, age 66, is a retiree with a conservative investment mix: 50 percent Fixed Account; 50 percent Financial Bond Fund. Now that Frank is retired and receiving his lifetime payments, he wants to ensure a steady flow of income. He has split his choice right down the middle: half in the fixed account, with its designated interest rate and guaranteed safety of principal, and half in the bond fund, with its high current income yield and emphasis on capital preservation. Barring any drastic changes in the economy, Frank will probably continue to rely on this investment selection for his annuity income.

Computation of Annuity Accumulation and Payments

Owners of variable annuities receive regular statements on the value of their investment accounts. Like CD owners and other investment holders, annuity owners want to know the current values of their holdings.

Computing the value at any given time of a variable annuity contract can be complex. With a variable annuity, one is dealing with fluctuating stock market investments. The process, therefore, is more complicated than calculating the value of a CD, which has a guaranteed interest rate over a specified time period.

Most insurance companies have adopted a unit method of expressing annuity values. Generally, two types of units form the variable annuity contract. These units correspond to the two basic time classifications for annuities: the period during which dollars are being accumulated (accumulation period) and the period in which the insurance company makes the annuity payments (distribution period).

Accumulation Units

During the years in which premiums are paid into the contract, the annuity owner acquires accumulation units. Accumulation units have a designated initial price at the time of the annuity purchase, but fluctuate in value thereafter. In the case of company-managed products, the changing values will correspond to the performance of the pool of investments. This is similar to the way mutual fund values are expressed. With a mutual fund share, each accumulation unit of a variable annuity has a designated value on a given day. In the case of self-directed annuities, the values of the fund or combination of funds the policy owner has chosen are totaled. The value of each accumulation unit is then calculated from this total.

Under both company-managed and self-directed plans, each premium payment purchases a certain number of accumulation units. The number of units varies according to the unit's current market value. The number of units continues to increase as additional purchases are made, although each unit's value will vary over the life of the contract, according to its worth in the marketplace. This, too, is similar to the manner in which mutual fund share values are calculated.

The following example illustrates how this works out in practice:

| | |
|--|-------|
| Initial Value of Accumulation Unit on 1/1/04 | \$5 |
| Monthly Premium Payment | \$100 |
| Initial Number of Units Purchased | 20 |

| Subsequent Accumulation | Unit Values | Number of Units Purchased |
|-------------------------|-------------|---------------------------|
| 2/1/04 | \$5.05 | 19.80 |
| 3/1/04 | \$4.87 | 20.53 |
| 4/1/04 | \$4.94 | 20.24 |
| 5/1/04 | \$4.99 | 20.04 |
| 6/1/04 | \$5.12 | 19.53 |

At the end of the six-month period, the owner will have a total of 120.14 accumulation units. As stated above, the value of these units will continue to fluctuate according to the unit's market value. With each premium payment, the contract owner adds to the total of accumulation units. The accumulation unit price will probably continue to fluctuate. When the annuity matures, the contract owner will have been credited with a specified number of accumulation units.

Annuity Units

In order for the insurance company to begin paying out income from the annuity, accumulation units are converted into annuity units.

An annuity unit is a measure of value that an insurance company uses when it calculates the amount of income to be paid to an annuitant. At retirement, the annuitant is credited with a designated number of annuity units.

The exact number of annuity units to be credited depends on four basic factors.

The first factor is the annuitant's age. As described earlier, the insurance company calculates from its mortality tables all charges in order to provide a designated amount of lifetime income at a specified age.

The second factor is the number of guaranteed payments. If the annuitant chooses a period certain life income option, the extra charge for that benefit will be reflected in the calculation of the annuity unit.

The third factor is the interest rate that the insurance company projects. If the company predicts a fairly high interest rate, the annuity unit will have a greater value than it would with a lower rate. Interest rates typically are projected annually to determine the projected investment return.

Finally, there are administrative expenses to be incorporated into the unit cost calculation.

Fluctuating Value of Annuity Units

The calculated number of annuity units remains constant over the payment period. The annuitant has the option of choosing a fixed or a variable payment, or, as is often the case, a combination of both.

With the variable payout, the annuity unit's value may fluctuate, just as it does during the accumulation period. The value will continue to vary according to the performance of the underlying investment portfolio and the general administrative costs that the company incurs. Obviously, the amount of periodic income also will fluctuate.

For example, suppose that on January 1, the date the annuitant retires, he or she has collected a total of 10,000 accumulation units. Assume further that at that time the 10,000 units have a market value of \$50,000.

Using the above process, the insurance company then converts the annuitant's 10,000 accumulation units to 100 annuity units.

On the first payment, each annuity unit is worth \$10. If the annuitant chooses the fixed payment option, the \$1,000 monthly payment, as listed in the example below as of January 1, would remain constant for the balance of the payout period.

Assume that the annuitant chose a variable mode of payment. In that case, a six-month projection of monthly payments would be as follows:

| Date | Annuity Unit Value | Monthly Payment to Annuitant |
|------|--------------------|------------------------------|
| 1/1 | \$ 10.00 | \$ 1,000 |
| 2/1 | 10.17 | 1,017 |
| 3/1 | 9.73 | 973 |
| 4/1 | 9.89 | 989 |
| 5/1 | 10.11 | 1,011 |
| 6/1 | 10.57 | 1,057 |

There are two important reasons for the continued fluctuation in variable annuities after the retirement income period begins.

The first is that the portfolio's value constantly changes to reflect current market conditions. The second is that the investments funding the annuity contract also change continually, just as they do during the accumulation period. The various stocks, bonds and other financial instruments that make up the portfolio continue to be bought and sold. In a company-managed plan, the insurance company's investment managers continue to supervise this process. In a self-directed plan, the contract owner may frequently change the contents of the portfolio.

Charges and Fees

Each contract typically has its own schedule of fees and other charges, and the investor should carefully assess these before making a purchase. Some companies impose management charges. Fairly typical contract charges are from \$0 to \$50 per year for administration, plus a few assess an investment management fee of 1 percent or more of the variable account's total value. Funds held in a fixed account usually escape the investment management fees. The insurance company typically justifies these fees by providing for a guaranteed death benefit and covering the administrative expenses involved in providing a life income.

Variable contracts are also known to charge a mortality fee which pays for the guaranteed death benefit. The purpose is to cover the insurer's overhead and commissions. These charges

generally run from .15 percent to 2.0 percent annually and it is usually a fixed rate that will not increase over time.

Example: Joan invests in a variable annuity and learns from the prospectus that a 1.25% mortality charge will be deducted from her account. In the first year her account value is \$20,000 resulting in a mortality charge of \$250. In the second year her account grows to \$25,000 resulting in a \$312.50 mortality charge and so on. It is interesting to note that even though the mortality charge is expressed as an annual charge it is calculated and subtracted from the contract value **each day**.

Dollar Cost Averaging

Investors who are little unsure of their ability to choose portfolio winners can invest using a simple risk-reduction technique called dollar cost averaging. The **concept** behind dollar cost averaging is that by spreading purchases over several types of variable subaccounts, potential highs and lows in each subaccount will be spread and ultimately averaged over time. Further, because units are bought at specific intervals, some units will be bought at low prices and some will be bought at high prices. The average is likely to be fairly constant.

Like fixed annuities, there are bonus plans that lure investors. When funds are placed in the fixed side of the variable plan, investors must be wary of their true yield since many offer teaser rates that later, when rates drop below base or promised levels, represent poor yields.

Death Benefit Guarantees (CIC 10168.4)

Most variable annuities include a guaranteed death benefit that pays out upon the death of the annuitant. The amount the beneficiary receives is typically the **greater of** . . .

- The original invested amount plus additional contributions less any withdrawals OR
- The value of the account less any withdrawals

Example: Bob invests \$150,000 in a variable annuity and later adds another \$100,000. Along the way, however, Bob withdrew about \$50,000 to cover some unanticipated taxes. At the time of the annuitant's death, Bob's account was valued at over \$500,000. What is his death benefit? The greater of the investment or account value would be \$500,000, less the \$50,000 or a death benefit of \$450,000.

Of course, the death benefit does not last forever. When the annuitant reaches annuitization age . . . anywhere from 75 to 90 . . . the death benefit ceases. Furthermore, some companies charge a mortality fee to pay for the death benefit guarantee ranging from .15 to 2.0% per year of the account value.

Many companies also offer the ability to improve the death benefit amount to an amount equal to the account value or many times the account value as an incentive to purchase. Others allow investors to **step-up** the death benefit by periodically renewing an owner's contract with a new surrender penalty schedule.

Example: Fritz purchased a \$100,000 variable annuity with a penalty period of five years. During the time Fritz owned his contract his account value bounced around from \$150,000 to \$250,000. At the end of five years, Fritzs' withdrawal penalties have faded away and the value of his account is \$200,000. Fitz is concerned that his account value could fluctuate more over

the next five years so he accepts his insurer's offer to step-up his death benefit to a minimum of \$200,000 . . . his current account value. In exchange, the insurer restarts another five-year withdrawal penalty schedule.

California, like many states, has passed minimum nonforfeiture laws. The purpose of such laws is to make sure that contract owners receive **something** when and if he stops making premiums. Most annuity contracts provide cash surrender values benefits prior to maturity. California law states that in no even shall any cash value surrender benefit be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.

Living Benefit Guarantees / Benefits

As the market for variable annuities becomes more competitive, insurers are "sweetening the pot" to attract more business. One such perk is to offer living benefit guarantees. Such a guarantee might protect your mutual fund investments against losses if you hold the investment for a period of time. Other living-benefit guarantees might promise to pay a guaranteed retirement income, regardless of the investment account performs, long term care expenses, etc. It is important to know if what you must do to "earn" this benefit, e.g., convert the contract to an immediate annuity or annuitize. Like any form of insurance, there is usually a cost.

Example: Joan's variable annuity includes a living benefit option that guarantees a minimum future amount of income. Regardless of how her investment options perform, on her 10th or later contract anniversary, she can convert her contract to a guaranteed amount of income.

Living benefits are optional and exercisable at the discretion of the policyholder. The more these benefits come into play, the more the pricing is challenging. There is also discussion on the effect these options may have on insurers. More aggressive companies, for example, could experience problems if the stock market continues to perform poorly for an extended time period. In a catastrophe, the cost they charge for the benefits would be inadequate."

Performance and Investor Considerations

The initial objective of the variable annuity concept was to design a financial instrument that would combine the guaranteed features of annuities and the growth possibilities of equities.

One popular theory was that the cost of living and common stock prices tend to move in the same direction over the long run. During the 1950s and 1960s, there did seem to be a definite correlation between rising stock prices and the cost of living. However, a comparison of the consumer price index and Standard and Poor's index of 500 stocks from 1970 to present day shows wide fluctuation, even during periods of accelerated inflation. In the 1970's some variable funds dropped by almost 40 percent in a matter of a few years at the same time inflation was skyrocketing. Individuals who already had started drawing their annuity benefits saw their payments decrease, while the cost of living increased. Not only did the downturn affect retirees, it also affected those who were still investing for the future. Therefore, even those who were still accumulating retirement funds were disappointed to learn that fund values did not appear to conform favorably to current economic conditions.

Some financial authorities have explained this phenomenon by proposing the existence of a definite relationship between inflation and stock prices. They point out that when prices rise rapidly, there is a corresponding increase in interest rates. When interest rates rise sharply, the

stock market reacts by moving in the opposite direction. Therefore, when the cost of living takes a sudden jump, it seems that the value of the variable annuity unit tends to fall.

Proponents of the variable annuity, however, assert that they have never viewed this product as a temporary hedge against sudden inflation. To them, the variable annuity is based on the assumption of a long-term correlation between inflation and investment returns.

Based on this principle, a variable annuity would be a favorable investment because it would allow investors to enjoy a rise in income as the economy's productivity increases.

Investor Considerations

The variable annuity, with its combination of traditional guarantees and investment flexibility, offers great promise as a financial planning tool. It has the potential to be more responsive to economic trends than the conventional savings account or even the traditional fixed annuity.

However, the savings customer who has basically considered only fixed investments should be aware of the special concerns connected with the purchase of a variable annuity.

Risk

There are two important points to keep in mind regarding the ***risks of variable annuities***. One concerns the ***insurance company*** that issues the annuity, and the second concerns the ***investment's fluctuating nature***. Regarding the first point, it is essential to note that, while both fixed and variable annuities are marketed by savings institutions, neither product is covered by federal insuring agencies. The investment is backed by the guarantees made by the insurance company that sells the annuity contract.

Although the insurance industry's record of financial stability has been very good, the annuity purchaser should investigate the company that issues the contract. While the savings institution marketing the annuity will have investigated the insurance company, the counselor must explain to the customer that government insurance does not apply to annuity products. In previous cases of insurance company failure, other insurance carriers have assumed the failed company's financial obligations.

However, this process has entailed some delays. Furthermore, although principal was safeguarded, the interest earnings promised in the original contract were not always credited to the investor.

The second area of risk -- the fluctuating nature of the variable annuity -- was discussed at length earlier. Investors should recognize that whenever they place money in variable annuities, the dollar value of their investments is subject to both upward and downward changes. An investor should assess his or her tolerance for risk when selecting a variable annuity and composing the annuity portfolio.

Particular caution is needed during the retirement period, when the contract owner may be contemplating changing investment strategies. Many owners take a more conservative investment position at this time than when they were making deposits and accumulating funds.

While it is possible to increase income payments by making the right investment choices, it is also possible to make the wrong decisions. Unlike during the accumulation period, when there is

sufficient time to make up for a temporary loss, once retirement begins, it is difficult to recoup any losses resulting from investment mistakes.

Choosing an Annuity Type

Determining which type of variable annuity is suitable for an investor depends mainly on two factors. One factor is the potential purchaser's investment sophistication. The other is the extent to which the person wishes to become involved in investment decisions.

The first consideration applies to the inexperienced investor with limited knowledge of the stock market. In this case, a company-managed variable annuity is probably the better choice, since the insurance company will make all the investment choices and manage the portfolio.

The second consideration concerns whether the contract owner wishes to continually monitor changing economic conditions and be responsible for changing the direction of investments in the annuity portfolio. With the self-directed type of variable annuity, the investor decides on the mix of investments in the portfolio. It is the contract owner's responsibility to periodically review these investments to see whether their performances are still in tune with his or her investment objectives, and adjust the portfolio accordingly. The self-directed plan is probably more suited to an investor who is accustomed to making these types of decisions.

Equity Annuity Options

In a general sort of way, the equity index annuity combines the traditional features of a fixed annuity which include;

- Guarantee of principal
- Tax deferral
- Free withdrawals
- Surrender charges when applicable . . . with;
- Current rates credited which are linked to the equity markets.

This type of annuity provides a rate of return that is determined as a defined share in the anticipated appreciation of a major stock index. The annuity will provide a guaranteed minimum return as do regular fixed annuities.

One of the major keys to the equity annuity is to allow the investor to participate in interest rates that are linked to the equity markets but avoiding the possibility of downside market risk.

So, a Equity Indexed Annuity (EIA) is a fixed annuity with traditional guaranteed minimum interest rates, with an excess interest feature that is linked to an equity index such as the S&P 500 (explained below).

The contractual features of the annuity fit within the general definition of a non-security that mark it as an insurance product not requiring a securities license.

What is probably more important are the differences between the various Equity Index Annuities and how the index or interest calculation is made. There are also substantial variation between company designs, and quite frankly, no two products are alike.

Equity Index Annuity Investments

The EIA is a fixed annuity and the lion's share of EIA premium dollars are invested in the same types of fixed-rate investments that insurance companies use to support their traditional fixed interest annuities. In a traditional fixed annuity, current (or excess) interest is paid in the form of a declared current crediting rate. In an EIA, current (or excess) interest is paid in the form of participation in the equity index.

Again, the major part of the investments cover the underlying minimum contract value guarantee. The carrier deducts a percentage of their investment earnings (called a "spread") to pay for expenses and their profit margin. The balance is used to purchase future participation in the equity index growth. The company can hedge future index growth by buying call options. They may buy them directly on the ex change floor or from a third party like a bank.

It may seem counterintuitive but the level of the S&P 500 Index or the current direction of the stock market is not the significant factor in setting participation rates. In fact, it is the level of current interest rates that actually determines the amount of stock market participation the company can offer. The higher current market rates, the more investment earnings are available with which to purchase call options which then allows a higher participation and cap rate.

The cap permits the company to offer a higher participation rate by setting an upside limit on the index growth. If the Index increases over the cap, the carrier does not keep the difference because they only hedged up to the limit of the cap.

Buying call options that are not used to actually hedge a liability is considered speculative and would be considered a high-risk transaction.

All things being equal, the higher the participation rate, the lower the cap and vice versa. Unfortunately or fortunately, depending on the understanding of the insurance producer, various combinations of the participation rate and cap rates are available even possibly in the same annuity product.

The Process of Indexing Explained

"Indexing" is an investment strategy that seeks to match the performance of a defined group of securities. This group of securities forms a recognized market measurement called an "index." An index is a benchmark or relative measurement of performance. One example is the Consumer Price Index that tracks the changes in prices of consumer goods from year to year.

Indexing seeks to match overall performance of the index, so the particular securities held and the quantity of each is pre-determined by the composition of the index. Investment managers for a S&P 500 Index fund will purchase each of the 500 stocks in proportions that match the index in order to replicate the performance of the index itself. Indexing is often called "passive investing" because the type and amount of each stock is decided by the index composition. This is in contrast to "actively managed" investing where a professional money manager devises unique strategies and investment philosophies in order to select individual securities. Indexing emphasizes diversification and by definition results in reduced trading activity.

Indexing arose from the "efficient market" theory of the 1960s, so it is not a new concept. If, as efficient market theory suggests, markets naturally tend toward optimum efficiency, it is questionable as to whether any strategy or philosophy can consistently outperform the market

(at least do so by a significant margin.) If efficient market theory holds true, then simply "buying the market" (or, indexing) will be the least risky and most effective investment strategy.

The historical performance of the stock market is clear - over the long term it has simply gone up. However, while the trend has been decidedly upward, there has been significant volatility with some extreme highs and lows over short-term periods. This daily volatility means that investors may experience significant increases or decreases to their principal within the course of a few days.

Indexing is a "buy and hold" investment strategy. "Buy and hold" (in the context of the S&P 500 tends to outperform an "active trading" strategy for the average investor. We know that the average investor over time has exhibited a "buy high, sell low" behavior that is detrimental to long term investment returns.

The advantages of indexing can be evaluated by considering the indexed mutual fund, one of the most popular investment vehicles of the '90's.

Interest Crediting Methods

Modern equity index annuities are currently utilizing the Standard & Poor's 500 Composite Stock Price Index more commonly known as the S&P 500 Index. This index is a widely recognized measure of equities in the US stock markets.

While the S&P Index is the most widely used index today you should also be familiar with other indexes that are and can be used. Some of these other indexes include the following;

- Standard & Poor 100 also known as the OEX Index
- S&P 400
- Nikkei National Index which represents the Tokyo stock exchange
- DAX Index which represents the German Exchange
- FTSE Index which represents the Financial Times Stock Exchange in London

There are also a number of insurance carriers that use some sort of internal operations to create the needed annuity returns using their own investment department instead of a major index. Others even may use a reinsurer to create the returns.

Monthly Averaging

In some annuities, the average of an index's value is used rather than the actual value of the index on a specified date. The index averaging may occur at the beginning, the end, or throughout the entire term of the annuity.

Averaging at the beginning of a term protects you from buying your annuity at a high point, which would reduce the amount of interest you might earn. Averaging at the end of the term protects you against severe declines in the index and losing index-linked interest as a result. On the other hand, averaging may reduce the amount of index-linked interest you earn when the index rises either near the start or at the end of the term.

The averaging modifier (modifiers serve to limit the Index Benefit by affecting the amount, timing and crediting of Index interest credits) serves to limit the S&P 500 Index growth to which the participation rates are applied. For example, if the market gained 1% per month each month for

one year, (e.g. from 500 to 563) it would be up a total of 12.67% at year-end. The average index value would be 532 or a 6.74% average annual increase.

Point to Point

Compares the change in the index at two discrete points in time, such as the beginning and ending dates of the contract term.

Advantage: May be combined with other features, such as higher cap and participation rates, that may credit you with more interest.

Disadvantage: Relies on single point in time to calculate interest. Therefore, even if the index that your annuity is linked to is going up throughout the term of your investment, if it declines dramatically on the last day of the term, then part or all of the earlier gain can be lost. Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early.

The index-linked interest, if any, is based on the difference between the index value at the end of the term and the index value at the start of the term. Interest is added to your annuity at the end of the term

Possibly the most basic type of equity index method is the ***Long-Term Point-to-Point*** method.

As the name implies, there are only two days in this index calculation method, the starting point and the ending point. For example, if Point A (the starting point) is 500 on an index and Point B (the ending point) is 550, then an unadulterated or pure Point-to-Point method would register a gain of 10 percent. That number would then be multiplied by the participation rate to determine the index gain for that period.

The ***annual point-to-point*** method uses an annual measure for calculating index returns.

So far, two pure Point-to-Point basic designs have emerged, the "Annual Point- and the "Long Term Point-to- In the classic unadulterated version of the Long Term Point-to-Point index method, the only days that count in the index gain calculation are the first day (the issue date) and the last day of the index term. Whatever the market did in between is IRRELEVANT. Only the first and last day of the entire index term count.

High-water Mark Designs

Looks at the index value at various points during the contract, usually annual anniversaries. It then takes the highest of these values and compares it to the index level at the start of the term.

Advantage: May credit you with more interest than other indexing methods and protect against declines in the index.

Disadvantage: Because interest is not credited until the end of the term, you may not receive any index-link gain if you surrender your EIA early. It can also be combined with other features; such as lower cap rates and participation rates that will limit the amount of interest you might gain each year.

Annual Reset

Compares the change in the index from the beginning to the end of each year. Any declines are ignored.

Advantage: Your gain is "locked in" each year.

Disadvantage: Can be combined with other features, such as lower cap rates and participation rates that will limit the amount of interest you might gain each year. This design, in all its variations, counts gains by the year, recognizes those gains, and locks them in so they are not lost in market downturns. All three zones of gain are counted.

Thus, you can see that Annual Point-to-Point designs of greater than one year generally have an annual reset of the starting point feature. Gains are registered below the initial starting point, which can be about half of the total possible gains. Also, all annual gains are added or combined together for a term total, as opposed to Long Term Point-to-Point, Average End, or High Water Anniversary Mark, Look-Back designs, where ONLY ONE point is derived from the index formula, and then a number and an effective annual yield are calculated.

Combination Methods

In an effort to give consumers even more choice, companies are assembling combination contracts that use many of the methods described above.

Spreads

In some annuities, the index-linked interest rate is computed by subtracting a specific percentage from any calculated change in the index. This percentage, sometimes referred to as the "margin," "spread," or "administrative fee," might be instead of, or in addition to, a participation rate. For example, if the calculated change in the index is 10%, your annuity might specify that 2.25% will be subtracted from the rate to determine the interest rate credited. In this example, the rate would be 7.75% ($10\% - 2.25\% = 7.75\%$). In this example, the company subtracts the percentage only if the change in the index produces a positive interest rate.

Cap Rates and Participation Rates

Another trade-off to consider is the long-term guarantee of the participation and cap rates.

A **cap rate** is the explicit maximum account value percentage increase allowed. The cap for an annual reset product is the maximum account value percentage increase allowed for a given policy year. A cap serves to set an upward limit on the client's Index Benefit. Cap rates are clear state limits on the index growth.

Participation rates represent the percentage of the increase in the index that will be credited to the accumulation value, which may be subject to the cap in some of the contracts. To add to some of the confusion already created, a contract with a 100% Participation Rate does not necessarily produce a greater Index Benefit than a contract with an 85% Participation Rate.

If guaranteed for the term, an 85% participation and 14% cap would become 65% and 12% respectively. Realize, you have a design similar to a traditional interest based annuity and a long term guarantee of these participation and cap rates would create significant surplus strain

(just like it does for an interest based fixed annuity. Ever notice that traditional interest based annuities' long term rate guarantees are lower than the current, year to year guarantees?) Similar to "company practice" with interest based annuities, it is the company's intention to maintain the participation and cap rates for the length of the term. The bottom line ... if you deal with a reputable carrier with a reputation for fair and honest renewal rates, the annual reset design will provide the intended benefits and results.

Caution: Some EIAs allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features.

Minimum Interest Guarantee

One of the EIA features that is most commonly misunderstood is the minimum contract value. This value is an underlying secondary guarantee or "safety net" that ensures a guaranteed minimum cash value is available to the consumer.

The minimum contract value is guaranteed regardless of how the index performs. (Index performance is reflected through index increase credits to the current accumulation value.) So if the index stays flat or declines over the entire term of the contract (so that effectively, no index increases are earned) this minimum contract value comes into play. Of course, the likelihood that the Index will remain perfectly flat or consistently decline over a long period of time is statistically small. However, this guarantee exists to accommodate that scenario.

When calculating "cash value" benefits, such as a surrender value, death benefit, annuitization - value or withdrawal the buyer always receives the greater of the current accumulation value or the minimum contract value guarantee. In non-registered products, this value must comply with minimum Non-Forfeiture Regulations, which for single premium contracts equals 90% of the premium at 3% interest compounded annually. (The regulation for flexible premium contracts is 65% at 3% interest compounded annually.) Today, the most common minimum contract value provision is 90% at 3% interest, which, for example, would equal 110% of principal at the end of a seven-year term. However, there are contracts that now guarantee 100% of premium at 3% interest and some flexible premium contracts guarantee less than 90% of premium at 3% interest.

Some contracts "top up" the minimum contract value at the end of a term to equal the current accumulation value as of the just ended term. This effectively increases the minimum contract value guarantee to reflect previously earned index credits.

In and of itself, the minimum contract value is not a particularly meaningful feature with which to compare the competitiveness of a product. In reality, this value will only be meaningful:

- Upon early surrender.
- If the index is flat or declines over the entire term.

Premature Surrender

If your client withdraws all or part of the value in his annuity before the end of the term, a withdrawal or surrender charge may be applied. A withdrawal charge is usually a percentage of the amount being withdrawn. The percentage may be reduced or eliminated after the annuity has been in force for a certain number of years. Sometimes the charge is a reduction in the interest rate credited to the annuity.

Some annuities credit none of the index-linked interest or only part of it if you take out all your money before the end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

Like fixed and variable contracts, EIAs may have a limited "free withdrawal" provision. This lets you make one or more withdrawals without charge each year. The size of the free withdrawal is limited to a set percentage of your annuity's guaranteed or accumulated value. If you make a larger withdrawal, you may pay withdrawal charges. You may also lose index-linked interest on amounts you withdraw.

Most annuities waive withdrawal charges on withdrawals made within a set number of days at the end of each term. Some annuities waive withdrawal charges if you are confined to a nursing home or diagnosed with a terminal illness. Your client may, however, lose index-linked interest on withdrawals.

Charges and Fees

Other than surrender charges (discussed above), most equity indexed annuities have no associated fees or charges. However, where participation rates are involved, administrative fees may be charged ranging from 1 percent to 2.5 percent annually. Contracts with less than 100 percent, however, typically do not charge such fees.

Annuity Riders

In an effort to be as competitive as possible, many annuity companies offer a myriad of annuity rider options. Some are available only at the time the contract is issued, others can be added later.

Life Insurance

Most contracts offer a standard death benefit payable upon the death of the annuitant. For additional fees, a rider can be purchased to enhance death benefit amount . . . say to double the amount of the original premium or total premiums invested. Others allow investors to **step-up** the death benefit to the account value of the contract by periodically renewing an owner's contract with a new surrender penalty schedule.

Living Benefits

Living benefits are optional and exercisable at the discretion of the policyholder. Such a guarantee might protect your mutual fund investments against losses if you hold the investment for a period of time. Other living-benefit guarantees might promise to pay a guaranteed retirement income, regardless of how the investment account performs.

Long Term Care Riders

A new crop of variable annuity insurers are offering riders that pay LTC benefits up to a maximum monthly limit for a certain period of years. Investors designate a portion of initial purchase payments to cover the benefits. The benefits wouldn't be reported as taxable income, in line with the Pension Protection Act of 2006. These policies function more like **long term care policies**. More traditional style contracts included long-term care riders that paid benefits when a serious illness occurs, even when no nursing home care is needed. For example, victims of strokes, heart attacks, cancer, coronary artery surgery, and renal failure can collect benefits while they are still living. Sometimes the policy holder can receive as much as 25 or 50 percent of the policy's face value up front, rather than in regular monthly payments.

Skilled Nursing Home Riders

A skilled nursing home rider would provide money for nursing home benefits . . . normally two percent of insurance coverage per month. By this rule, a \$100,000 policy would pay \$2,000 per month. However, if the policy is over \$150,000, the policy holder may get less than two percent. For example, suppose the policy holder has a \$300,000 life insurance policy with a long-term care rider, and he is confined to a nursing home. This insured may get two percent of the first \$150,000 (\$3,000) plus one-half percent of the next \$150,000 (\$750) for a total of \$3,750 per month. Also, some policies place a limit on the monthly payment amount. . . Most policies require that the policy holder pay at least for the first 60 days of nursing home care before a long-term care rider kicks in. With some riders, the policy holder will have to make out-of-pocket payments for at least 180 days before he can collect. Some long-term care riders will not pay until the policy holder has been paying the extra premium for at least three years. For example, if an individual buys a long-term care rider in 1997, he may not be able to collect before 2000, 2002, or some other date.

Most long-term care riders will pay for skilled care or intermediate care nursing home stays. However, some riders do not pay for custodial care. Others will pay only after a specified number of days in a hospital or a specified number of weeks in a skilled care or an intermediate care home. The problems with funding long term care coverage through an accelerated death benefit policy are obvious: Benefits may be slower than a stand alone policy, benefit triggers can be tricky and there is typically no inflation protection other than by expensive inflation riders. Furthermore, the death benefits that could have gone to an insured's estate are usually "eaten-up" in long term care costs thus defeating the purpose of buying a life insurance policy. Also, agents must be sure to differentiate between actual coverage and a simple **crisis waiver**, which allows the waiver of certain fees should a special illness develop.

Home Health and Hospice Rider

Some innovative plans pay up to 100% of allowed charges for home health care and up to 100% for hospice care. Many, however, come with lifetime maximums that can be as low as \$5,000.

Loan Provisions

Many annuity companies permit loans up to the contracts cash value. However, there are usually many statutory regulations, regarding maximum interest charged, repayment, disclaimers that the loan will offset any cash value or death benefit, etc.

When an annuity is inside a qualified plan, these requirements are even stricter where loans are limited to 1/2 of the current present value with a maximum repayment period of 5 years. In addition, loans must have a level amortization (repayment) plan.



PART V: Taxation of Annuities

One of the appeals of annuities is their income tax advantage and use in retirement planning.

RETIREMENT AND ANNUITIES

Annuities can play a role in anyone's retirement planning, although it is not the only option one should consider. The benefit of using annuities as part of a retirement strategy is the fact they are generally safe, provide tax advantages when accumulating and can provide guaranteed income for a specified period of time, like a **defined benefit pension**. Or, provide a payout at retirement based on the value of the account, much like a **defined contribution plan**.

Annuities can be purchased by an individual or purchased inside an **IRA, Roth IRA, Tax Sheltered Annuity (TSA 403b) or a Simplified Employee Pension (SEP)**. Many advisors shutter at the thought that someone would purchase a tax-deferred investment (annuity) inside a tax deferred vehicle like an IRA. However, if the investment is safe and makes sense from a yield standpoint we are not sure this is a big concern.

As a matter of review, annuities can be either tax qualified or non-tax qualified. A ***qualified annuity*** . . . annuity purchased with before-tax dollars . . . receive tax benefits not available to a non-qualified plan, but is subject to very strict government regulations. The employer receives a deduction when contributions are made to the plan. At least 70% of non-highly compensated employees must be covered by the plan, and government-set vesting schedules must be followed. Earnings accumulate tax-deferred and will be taxable to the individual at the time of distribution. No income tax deduction is available for the employer at the time of distribution. Independent contractors or directors are not eligible for coverage under a QRP.

A ***non-qualified annuity*** . . . annuity purchased with after-tax dollars outside employer-based retirement plan . . . are not subject to as many government regulations. Non-qualified contracts are purchased by individuals, executives or key employees, and not for a broader group of employees. Benefits provided to employees can go beyond the limits allowed in qualified plans. Any earnings within the plan currently will be taxable to the employer, and taxable to the employee when distributed as benefits. However, the employer will be entitled to an income tax deduction at the time of distribution. Independent contractors and directors are eligible for coverage under a non-qualified retirement plan, unlike a QRP.

PAYMENT OF PREMIUMS

Non-qualified annuities generally offer no deduction on contributions made to individual or group contracts . . . these contracts are purchased with after-tax dollars. On the other hand, such contracts have no limit as to the amount an individual can contribute. If an individual purchased an annuity inside his non-qualified IRA or pension plan, there would be a dollar-for-dollar corresponding deduction allowed for the premiums up to the current limit allowed . . . these contracts are bought with before-tax dollars. Premiums for annuities purchased inside a qualified plan can make a significant difference over time.

Example: John invests \$1,200 per year in a qualified variable annuity plan at work. Since there is no tax on the \$1,200 the full amount goes to work. And, in 30 years, at 8% yield, John will accumulate almost \$150,000. If John was investing outside the plan, with after tax dollars,

only \$864 is actually invested (assuming 28% went to taxes), leaving a pot of only \$69,000 in the same 30 years.

Why would someone invest outside a qualified plan? Well, annuities offer an alternative to qualified plans for those who have contributed as much as they can or who don't qualify to contribute at all.

CASH VALUE ACCRUAL / ACCUMULATION (CIC 10168.2)

An investment in an annuity, non-qualified or not, means that money will grow and compound tax-deferred, **not tax free**. In other words, the income tax liability is postponed. The owner may be a natural or non-natural person. Some examples of non-natural persons are corporations, partnerships, and trusts. Generally, annuity contracts owned by non-natural persons are not treated as annuity contracts for federal income tax purposes and the earnings on such contracts are taxed annually as ordinary income received or accrued by the owner during the taxable year.

Considering the tax deferral nature of annuities, their use inside qualified plans is a hotly debated issue. Some argue that the tax deferral feature is lost inside a plan that is already tax deferred, others say that as long as the investment made is safe and produces an equivalent return, why not?

California, like many states, has passed minimum nonforfeiture laws. The purpose of such laws is to make sure that contract owners receive **something** when and if he stops making premiums. Most annuity contracts provide cash surrender values benefits prior to maturity. California law states that in no even shall any cash value surrender benefit be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.

PARTIAL WITHDRAWALS

Withdrawals from non-qualified or qualified annuities may be subject to ordinary income tax as well as penalties. Annuitization of the contract would be one way to soften the blow. Other options include systematic withdrawals, loans and full or partial surrenders, all of which can be utilized before an annuity's maturity date. However, current tax laws are such that any of these distribution options may create a taxable event

For annuities purchased before August 14, 1982, the general rule regarding cash withdrawals, amounts received as loans or amounts received on surrenders is that they are tax free until they equal the contract owner's basis or investment in the contract. After that, they are fully taxable as income. These annuities are given "first-in, first-out" (FIFO) treatment.

Annuities purchased on or after August 14, 1982, the general rule regarding these same kinds of distributions is that they will be treated first as fully taxable interest payments and only second as a recovery of non-taxable basis. These annuities are given "last-in, first-out" (LIFO) treatment.

In addition, there could be IRS penalties on any annuity withdrawal. To promote the use of annuities as retirement plans and to discourage their use as short-term tax-sheltered investments, a 10% penalty is imposed on "premature" distributions, or those taken before the contract owner's age 59½. Therefore, an individual who, at age 54, withdraws a sum of \$5,000

from his or her annuity will have to pay a current tax plus a \$500 penalty as well, to the extent the withdrawal is attributed to interest earnings. No penalty is imposed for distributions taken:

- After age 59½;
- In the event of disability;
- In the event of death; or as part of a series of substantially equal payments taken over life expectancy

One strategy by which annuities are sold is to buy while your tax bracket is high and withdraw when you are after age 59.5 and hopefully your bracket is much lower. Therefore, the income earned will be taxed at a lower rate without penalties.

Qualified v. Non-Qualified Withdrawals

For tax purposes, the IRS generally views premature distributions or withdrawals from qualified plans the same as non-qualified plans . . . they are taxed at ordinary income rates. The exception is where the withdrawal is a systematic withdrawal plan or annuitization. Here, an exclusion ratio can be applied to allow part return of principal and part taxable income. This is discussed further under Annuity Benefits Distribution below.

LOANS AND ASSIGNMENTS

Loans made from a non-qualified annuity have little tax consequence. However, in the case of qualified contracts there are several issues that could cause the amount loaned to be fully taxable:

Accounts under \$20,000 can loan out up to 80% of the account value up to a maximum of \$10,000. Accounts \$20,000 and over may loan out up to 50% of the value, not to exceed \$50,000.

Interest paid for tax-deferred annuity loans is not deductible.

Assignments of annuity contracts are considered distributions for tax purposes and will be included in an owner's gross income to the extent that the cash value pledged or assigned exceeds the original investment. Amounts pledged may also be subject to the IRS 10% penalty for owners under age 59.5.

EXCHANGES

Generally, the surrender of an existing non-qualified annuity contract is a taxable event since the contract owner must recognize any gain on the "old" contract as current income. However, under IRC Section 1035 when one annuity contract is exchanged for another, the transfer will be nontaxable, provided certain requirements are met. First of all, the exchange must take place before the contract has been annuitized. As to the actual mechanics of the exchange, the IRS has indicated through Private Letter Rulings that it will apply a strict interpretation to the rules. For a transaction to qualify as a 1035 Exchange, the "old" contract must actually be exchanged for a "new" contract. It is not sufficient for the policyholder to receive a check and apply the proceeds to the purchase of a new contract. The exchange must take place between the two insurance companies. Also, the tax code also says you can make a tax-free exchange from: 1) a life insurance contract to another life insurance contract or 2) from one

annuity contract to another annuity contract. You cannot, however, exchange an annuity contract for a life insurance contract.

Experts caution that it often does not make financial sense to exchange policies. First, some investors are exchanging policies because they are unhappy with how their contract or variable account has performed in recent years. But planners point out that many non-annuity investments also performed poorly during the same period. Second, a major drawback for exchanges is the potential for paying surrender fees. These are the penalties for canceling an annuity contract within a certain number of years after buying the annuity. A surrender fee might start around seven percent, for example, and decline to zero over seven years. Some surrender periods last ten years or more. If you exchange during that period, you could pay thousands of dollars in penalties. In addition, you'll be tied up with a fresh surrender period under the new contract.

Another factor to consider is whether it's worth the exchange just to get the new bells and whistles. Do you really need them? Are they worth the cost of the exchange, particularly if the old contract's surrender fees are high or the new annuity has higher costs due to the new bells and whistles?

In addition, you may end up with a newer life expectancy table than you had under the old annuity, which can lower payouts should you annuitize. That's because with people living longer today, newer life expectancy tables won't pay out as much for each dollar of annuity value, versus an older policy with a table based on a shorter life expectancy.

In some exchanges, you may lose a portion of your death benefits if the value of your annuity is less than the contractually guaranteed death benefit. This is a distinct possibility for annuities whose value declined during the recent bear market. If the value is less than your original investment, some planners recommend simply cashing out and taking a tax deduction.

None of this is to say exchanges should never be made. The important point is that every situation is unique and you need to conduct a thorough analysis to determine whether it is economically worth switching. In some cases, it might be better to keep the old annuity and buy a new variable annuity with new money if it has benefits you want.

For qualified plans, an exchange or liquidation within the structure of the plans administration, i.e., a trustee-to-trustee transfer, can generally be accomplished without triggering a tax.

GIFT OF AN ANNUITY

There are many strategies used by agents to sell annuities. One suggests the establishment of a gifting program to give a newborn child or grandchild an annuity through a joint spousal gift of \$20,000 per year for 18 years. Assuming the annuity earns 7% annually, at age 18 the child can withdraw \$10,000 per year for four years to help fund the child's college education. Then, at age 30, another \$25,000 could be taken for a home purchase. Finally, at age 65 the lucky child/grandchild could begin receiving \$20,000 per year, and at age 80 still have more than \$800,000 left.

The footnote to this strategy must read that earnings taken from an annuity before age 59 1/2 are taxable as ordinary income and... may be subject to a 10% federal tax penalty. Result? In a 15% tax bracket, that \$10,000 withdrawal for college expenses would only amount to \$7,500 after income taxes and penalty.

SALE OF AN ANNUITY BY OWNER

A liquidation or sale of an annuity contract by the owner can generate a taxable event. When an annuity contract is fully surrendered during the accumulation phase, the owner must pay income tax on the earnings in the contract. The owner is not taxed on amounts that represent a return of contributions (such as premiums or investment in the contract). In essence, the tax consequence is the same as discussed under partial withdrawals. An option to reduce taxes is to annuitize the contract. A discussion of how this works is discussed in the next section.

DEATH OF AN ANNUITY OWNER (CIC 10168.2)

Non-qualified contracts: If the owner dies during the accumulation phase, the entire death benefit must be distributed ***within five years*** of the date of the owner's death. However, there is an exception to the five-year rule, if the death benefit is paid as an annuity over the life, or a period not longer than the life expectancy, of the beneficiary and the payments start within one year of the owner's date of death. If an annuity contract has joint owners, the distribution at death rules are applied upon the first death.

Under a special exception to the distribution at death rules, if the beneficiary is the surviving spouse of the owner, the annuity contract may be continued with the surviving spouse as the owner. If the owner of the annuity is a non-natural owner, then the annuitant's death triggers the distribution at death rules. In addition, the distribution at death rules are also triggered by a change in the annuitant on an annuity contract owned by a non-natural person.

Unlike death benefits paid from life insurance policies, the beneficiary may be taxed on distributions made from an annuity after the owner's death. Amounts paid under the five-year rule are taxed in the same manner as partial withdrawals or full surrenders, and amounts paid under an annuity option are taxed in the same manner as annuity payments at ***ordinary tax rates***. For variable annuity contracts issued on or after 10/29/79, and for all fixed annuity contracts, there is no "step-up" in basis for income tax purposes and the beneficiary pays income tax on the earnings. However, the beneficiary is entitled to deduct a portion of estate tax paid on the annuity for income tax purposes. For variable annuity contracts issued prior to 10/21/79, there is a "step-up" in basis for income tax purposes and no income tax is payable on the earnings.

If the owner dies after the annuitization phase has begun, the remaining payments, if any, must be paid out at least as rapidly as under the annuity payout option in effect at the time of the owner's death. If a beneficiary receives the remaining payments under the annuity payout option in effect at the owner's death, the taxable and nontaxable portions of such payments will continue to be determined by the original exclusion ratio (discussed below).

California, like many states, has passed minimum nonforfeiture laws (***CIC 10168.2***). The purpose of such laws is to make sure that contract beneficiaries receive ***something*** when premiums cease or at the owner's death. Most annuity contracts provide cash surrender values benefits prior to maturity. California law states that in no even shall any cash value surrender benefit be less than the minimum nonforfeiture amount at that time. And, the death benefit under such contracts shall be at least equal to the cash surrender benefit.

Also of note is the fact that distributions that occur when a contract owner dies are exempt from the 10 percent IRS penalty for any owner under age 59.5 years of age.

Qualified Contracts: The **distribution** of an annuity contract inside a qualified plan are the same as other qualified plan distributions. By law, anyone can be named as beneficiary of an qualified plan. Spouse beneficiaries can roll over the death proceeds of the IRA account into an IRA for themselves and thus avoid any taxation until withdrawals begin. Nonspouse beneficiaries must generally pay income tax upon receipt of the proceeds, excluding any nondeductible contributions the participant may have made. However, distributions to a nonspousal beneficiary may often be spread out over a number of years to avoid paying the tax all at once.

Recently, the IRS issued new rules that greatly simplify the calculation of required minimum distributions. Now, upon an IRA owner or plan participant's death, a designated beneficiary may base distributions on his or her life expectancy.

DEATH OF AN ANNUITANT

Since the annuitant is the measuring party in an insurance contract, his death may trigger a myriad of options. In a **non-qualified contract**, the effect on taxes depends on who is the annuitant? In the case where a husband is both the owner and annuitant of the contract, his death means the spouse can continue the contract and all tax deferral or receive death benefits under the distribution at death rules. When the annuitant is someone other than a spouse, the distribution at death rules are triggered.

The **distribution at death rules** state that the balance of any annuity contract may be paid by lump sum; over five years or over the life expectancy of the beneficiary. The tax effect of any choice can be as much as the gain of the contract over it's investment at **ordinary tax rates** or an ordinary tax rate adjustment over time using the exclusion ratio discussed below.

For **non-qualified contracts**, an annuitant's death may trigger a complete liquidation or annuitization of the contract. Here again, spouse beneficiaries can roll over the death proceeds of the IRA account into an IRA for themselves and thus avoid any taxation until withdrawals begin. Nonspouse beneficiaries must generally pay income tax upon receipt of the proceeds, excluding any nondeductible contributions the participant may have made. However, distributions to a nonspousal beneficiary may often be spread out over a number of years to avoid paying the tax all at once.

ANNUITY BENEFITS DISTRIBUTIONS

Because annuities receive favorable tax-deferred treatment, over a period of years a "pot of money" placed in an annuity can grow to a larger sum compared to an investment, like a CD, where the earnings are being taxed at the investors marginal tax rate. For example, a \$10,000 investment at 6% **tax-deferred compound interest** will grow to \$57,435. Of course, at distribution time, there is a tax to pay (discussed below). If one could find a **tax-free** 6% alternative (such as a tax free municipal bond) it would grow to the same amount with no tax. Such investments are not typical and do come with a risk of principal. The same \$10,000 in a taxable CD, assuming a 28% marginal tax would grow to only \$35,565.

When an annuity is ready to payout, there are several distribution options. Clients can take a lump sum, make partial withdrawals or annuitize the contract with annual payments of both

principal and interest. Under **non-qualified contracts**, the amount of each annuity payment that **won't be taxed** is computed using an **exclusion ratio**, which is determined by dividing the net investment in the contract by the total amount expected to be distributed during the payout period.

Example: Steve has a fixed annuity in which has a net investment of \$100,000 that will pay \$750 per month for life starting at age 62. According to IRS life expectancy tables, Steve will receive those payments for 22.5 years, so the contract's value is \$202,500 (12 X \$750 X 22.5). The exclusion ratio is 49.4 percent ($\$100,000/\$202,500$). So, out of the \$9,000 the annuity pays each year, Steve may exclude \$4,446 from income. The remaining \$4,554 of that payment will be subject to ordinary income taxes. In the case of a lump sum distribution, Steve would have been responsible for the increased value of his annuity over his original investment as ordinary income.

In **qualified contracts**, clients willing to take their distributions in periodic payments a similar tax break is granted. However, the IRS sets forth three methods for determining whether payments to individuals from their IRAs or from their qualified retirement plans constitute a series of substantially equal periodic payments. The three methods are: (i) the required minimum distribution method; (ii) the fixed amortization method; and (iii) the fixed annuitization method. Under the **required minimum distribution method**, the annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. See Rev. Rul. 2002-62 § 2.02(a) (life expectancy tables).

Under the **fixed amortization method**, the annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined by using the chosen life expectancy table and the chosen interest rate. See Rev. Rul. 2002-62 § 2.02(a) (interest rates).

Under the **fixed annuitization method**, the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of \$1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the taxpayer and beneficiary). The annuity factor is derived using the mortality table in Appendix B to Rev. Rul. 2002-62 and using the chosen interest rate.

Once an accepted method is chosen your client will be taxed on the distribution from his plan minus a prorated part of any investment in the plan (paid with after-tax dollars or contributed by an employer but taxable to the client). If he has no costs, then his entire distribution is taxed.

BENEFICIARY TAX ISSUES

Like the beneficiary in a life insurance policy, the annuity beneficiary has no voice in the control or management of the contract. He can only prosper when something happens to the annuitant. When this does occur, the beneficiary may have several settlement options: A lump sum, fixed payments for a certain period, payments for life, etc -- all of which have pending tax consequences.

The **goal in structuring or titling an annuities** should be to maximize the payout options your client has available when upon death of the annuitant or when exiting the contract and/or at the same time minimize any tax or penalties. Tax and estate favorable annuity payout options might involve **annuitization** or distribution of your client's annuity value over five years, his life expectancy, a fixed period of time (10 years, 15 years, etc) or as a lump sum, say within 60

days of the annuitant' death. Also, you should consider the ability for a surviving spouse to continue the contract for the remainder of his or her lifetime.

DISCLAIMERS (CIC 789, AB 2107)

New legislation requires California agents to uphold a duty of honesty and fair dealing and establishes special handling where seniors and Medi-Cal eligibility is concerned. There are specific disclosures you must provide clients, some of which are discussed in Attachment III at the back of this course. In particular, AB 2107 strengthens the Elder Abuse and Dependent Civil Protection Act with respect to selling insurance and financial products to elders by defining what is abuse and outlining required disclosures needed when you are suggesting a financial product geared to Medi-Cal eligibility. Others involve a responsibility to apprise clients on the following issues:

1. If a life agent offers to sell to a client any life insurance or annuity product, the life agent shall advise the client or the client's agent in writing that the sale or liquidation of this product may have tax consequences.
2. The life agent shall disclose that the client may wish to consult independent legal counsel or financial advice before buying, selling or liquidating any assets being solicited or offered for sale.
3. A life agent shall not provide detailed advice with issues surrounding income and estate taxation of annuities. If expert tax assistance is required, life agents shall advise client to consult with a professional.

There are severe and long-range penalties and consequences for violating these disclaimers. Most are included in the Section 789 of the California Insurance Code. Before this course is completed, we will discuss many of these rules.



PART VI: Qualified Plans & Annuities

ANNUITY MARKETS AND BUYERS

Investors moving closer to retirement are determined to guarantee some portion of their retirement income in the midst of what has turned into a very frightening bear market that, in many cases, has taken a big bite out of their retirement accounts.

Fear, pent-up frustration with ongoing stock market losses and the uncertain financial future those losses have created are encouraging all types of investors, including the very wealthy, to seek guarantees for retirement. That's reflected in a notable uptick in new annuity sales after years of declining net cash flows.

Advisors, even those who had the luxury of viewing annuities as expensive and unnecessary in the long-running bull market, are now taking a hard look at the contracts. They realize that clients in retirement not only want, but have begun to demand, some level of certain retirement income . . . an income they cannot outlive.

That demand is certain to grow as the baby boomers begin their retirement stampede, the majority of them with eroding nest eggs and without determinate pension distributions. In combination with the fact that people are planning to live and work longer than before means that annuities can play a significant role in extending their incomes.

Insurers, advisors and investors have begun to think not just about asset accumulation, but lifetime income and ways to preserve and direct income in retirement. Annuitization is one of the few ways to do that.

Interest rates may indeed be at historical lows when it comes to finding pay-out guarantees, but that hasn't stopped the industry from doing full-scale and targeted product development. There's a greater focus now on what customers need and ways they can customize products to meet their needs.

Many in the industry believe that annuities are positioned to capture a portion of the multi-trillion dollar retirement rollover and conversion market in the coming decade. This can indeed be good news for agents who have had a tough time during the past several years.

Another incentive is the push in Congress to offer tax breaks to retirees who annuitize some portion of their retirement plan payouts.

With billions in fixed and immediate annuity payout liabilities sitting on insurers' books, there is some justifiable concern regarding individual companies' going concern value and their ability to pay your clients' life-time income. It's also a matter of making a judgment call regarding interest rates and the fundamentals of the stock market, especially if investors have a longer investment horizon.

***Who Buys Annuities?*³**

The annuity market developed from a fundamental change in demographics since the end of World War II. The generation that began retiring in the mid-1980s was the generation that fought World War II, the generation that has been celebrated today as “America’s greatest generation.” Previous generations of American had faced dire economic circumstances, providing case material for books such as Michael Harrington’s 1962 classic, *The Other America: Poverty in the United States* [New York: Macmillan, 1962], a book that deeply impacted President Kennedy and directly led to Lyndon Johnson’s War on Poverty. The World War II generation had enjoyed the prosperity sustained American economic growth. Their retirement prospects were dramatically improved over the difficulties their own parents faced in retirement.

By the mid-1980s, retirees were taking with them substantial pensions. The largest-ever Social Security benefits contributed substantially toward meeting their daily needs. The value of the fundamental investment, the family home, had benefited from decades of inflationary growth in real estate prices. Having grown up as children in the Depression, the retirees in the mid-1980s had a savings mentality. They were not spenders and they did not live on credit. With pensions realized and the family home in many instances sold, this retirement generation often had more accumulated savings than they had ever experienced in their working careers.

Annuities were a perfect product. The World War II generation flocked to the safety, high yield and tax-deferred appreciation that were the bedrock features of life insurance industry’s neglected annuity offering. In a bank, the conversion of a CD to an annuity sale could be completed in a 45-minute flip-chart presentation delivered by a licensed agent who was trained to keep to the script. Third Party Marketers learned to contact CD owners at CD maturity to offer them annuities during the decision window when a CD had to be renewed. The most astute bank marketers learned to target annuities maturing in uneven amounts, knowing that CD buyers usually purchased CDs in round numbers. Uneven maturity amounts signaled that the CD owner was not living on the interest earnings, so leaving funds in an annuity to appreciate tax-deferred would not be a sales objection.

In 1980, no banks were selling annuities. Today, some 20 years later, there is hardly a major financial institution in the United States that does not have an annuity sales force generating substantial fee income from annuity commissions.

Variable Annuities Emerge: The Stock Market Takes Off

Creative marketers such as Harry Copeland of VALIC developed variable annuities to free annuities from the restraints of fixed interest rate returns. By “wrapping” what amounted to mutual funds within an annuity “cover,” the variable annuity could obtain investment returns compounded within a tax-deferred setting. When the US Supreme Court decided in the VALIC case that Mr. Copeland and his associates were right, the law of the land was set. [SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 69 (1959)] The Supreme Court case in VALIC broke the first set of barriers the variable annuity faced. Despite its essentially investment-oriented nature, the variable annuity was now to be considered a life insurance product for purposes of government regulation and taxation. The legal and regulatory challenges were moved aside. What remained now were the marketing challenges.

³ Jerome R. Corsie, Harvard University / www.USAgent.com

The variable annuity fully came of age with the bull market of the 1990s. The argument had always been valid that the long-term results of equity investing could be expected to outperform the fixed returns of interest rates. Still, nothing fueled variable annuity growth like the double digit returns being regularly returned year after year in virtually all market categories of equity investing in both the New York Stock Exchange and the technology-oriented NASDAQ. In the heyday of the Internet's expansion, when anything named "dot com" meant instant wealth, the argument for variable annuities was nearly irresistible. Stockbrokers had always offered variable annuities as the "tax deferred way" to own mutual funds. In the late 1990s, with the NYSE raging past 10,000, even banks offered variable annuities to their conservative retirement customers who simply wanted more yield on their annuities. Annuities, with the variable version gaining momentum, finally broke the barrier of being a fixed income product by definition.

Life insurance agents who had resisted becoming securities licensed simply to sell mutual funds found in the 1990s that they had to take their Series 6 or Series 7 NASD exam to remain competitive in their ability to offer their clients variable life and annuity products. Mutual fund companies formed alliances with insurance companies and variable annuities with successful brand names began to bring in premium dollars measured in the billions. The marriage of the life insurance and securities industry around variable products looked like a phenomenon here to stay – that is, until the stock market began to run out of gas in the final months of the Clinton Administration.

The NASDAQ crashed, losing more than half its value as "dot com" companies changed overnight from being regarded as miracle children to being cast as pariahs. Variable annuities, on which fixed income customers saw a totally unanticipated loss, suddenly became as welcome as the plague. The only hope for variable products was the "hybrid" versions which had marketed a strong "fixed bucket," a traditional interest rate return investment alternative among the mix of investment options placed within the product as investment options. Traditional savers who had been tempted to variable annuities for more yield rather than any true investment understanding or desire began to regret that they had ever listened to sales pitches delivered by stock peddlers masquerading as insurance experts.

The Indexed Annuity: The Fixed Annuity with a Twist

Even as the 1990s wound to a close, the investment world was not about to abandon hope that the insurance industry remained a marketing opportunity. A new product began to make the scene – the Indexed Annuity, a fixed annuity in which the investment company continued to bear the investment risk, packaged with an equities index that could boost the stated yield if the securities to which the index were pegged performed well in the market. The idea was to allow the customer to share on the upside of a stock market gain, without having to risk principle invested in an annuity or life insurance contract.

The concept was simple, but the execution was complex. Equity indexes were hard to understand and even harder to explain to customers who were not financially sophisticated. To make the product work, guarantees of principle were generally defined to apply only if the customer left premium in the contract for a considerable period of time. Surrender charges and withdrawal penalties extended to previously unacceptable lengths, frequently lasting 10 years or more in indexed annuities. Company lawyers had to work overtime to make sure that the indexed gains did not create investment risk for the consumer, struggling to keep the product definition from becoming a true "variable" product subject to securities registration and regulation.

The desired result was obtained. The indexed annuity offered a fixed rate of return, guarantee of premium and the possibility of participating in market gains on the upside. The difficult nature of the product, however, limited its market appeal. Many customers who wanted to purchase indexed annuities could not get a licensed representative to explain it simply enough that it was easy to understand. Just reading the sales literature, usually the most intuitive literature life insurance companies produce, demanded more than the average customer or salesperson could easily master.

Year 2000: Annuity Marketing Enters a New Era

The economic slowdown that began during the Clinton Administration when the Internet bubble burst, continued through the Bush Administration, sharpened by the economic fallout resulting from the September 11 attack on the World Trade Center. The Federal Reserve fought a rear guard action reducing interest rates to historically low levels. The resulting pressure sent fixed income customers scrambling.

Variable annuities were touted by stock brokers who were also urging customers to invest in mutual funds as the market was bottoming, a counterintuitive move that derives support from sound investment principles. Index annuities remained an alternative for customers gun-shy from taking investment risk after witnessing a stock market roller coaster ride that was unusually harrowing. Still, the annuity market did not slow down. The year 2001 looks positioned to hit new highs, with over \$100 billion for the first time.

Why the continued strength in annuity marketing? Simple – the tax-averse fixed income customer has few other safe alternatives. Banks, whose \$20 billion in annual annuity sales represents 1/5 of the US annuity market, typically sell in the non-qualified market, transferring tax-susceptible dollars in CDs into tax-deferred dollars in annuities. The qualified annuity market, still dominated by expert agents with advanced underwriting skills, continues to account for the lion's share of the annual annuity premium.

The life agent seeking to reposition qualified funds from complicated plan designs using securities investments as funding vehicles is equipped with important inherent advantages. Annuities are one of the few investment vehicles that qualify as a tax-qualified investment without the creation of a specific trust within which the otherwise non-qualified investment such as a mutual fund must be placed. The simplicity of using the annuity as a tax-qualified option allows the trained life insurance agent to emphasize the safety of the investment and focus on unique annuity advantages, such as lifetime payout and joint survivor options. The annuity used as a qualified plan comes pre-packaged with a death benefit that bypasses probate by its very nature. Banks can easily scour their databases to identify maturing CDs that can be targeted for annuity marketing. Yet agents control the retirement pension market, ranging from 401(k) programs to IRAs to Tax Savings Annuities designed for teachers and the 403(b) market for public employees. In the tax-qualified pension market the trained life insurance agent shines.

Penetrating the tax-qualified pension market also requires the type of marketing skills generally mastered only by the experienced life insurance agents who manage to survive the first difficult years of finding prospects. While banks have as commercial banking clients the corporations that provide many of America's largest pension programs, few banks have mastered the cross-sell required in transferring a customer from the fiefdom of the corporate banking relationship to the still fledgling insurance services program. Stockbrokers remain transaction oriented, lacking the patience required to position annuities as pension investment alternatives. Teachers and public employees expect their annuity pensions to be sold by life insurance marketing

specialists, not banks or brokerage firms. As we enter the year 2001, nearly \$80 billion a year in new annuity premiums remain the domain of the life insurance agent and broker.

What does the future hold? The answer involves yet unseen dimensions in an expanding retirement market. The aging of the US population is a trend likely to continue given the advances we have witnessed in the ability of medical science to extend life to new limits. Banks and brokers continue to be locked in traditional marketing straitjackets, despite efforts to expand their horizons. The challenges in the future are challenges exactly suited for the life insurance industry. As individual lifetimes beyond 80 years of age become more common and centenarians are no longer an oddity, the new frontier of retirement planning will involve extended payouts, making sure there are sufficient resources to provide financial security through lengthened periods of active retirement years.

Positioned initially to protect the risk of “dying too soon,” the life insurance industry is placing increased emphasis upon protecting the risk of “living too long.” At \$100 billion in annual premium, the annuity market is no longer a neglected stepchild. In a dramatic reversal of position, the annuity has moved to become one of the life insurance industry’s most reliable sources of growth. Today every life insurance agent planning a productive career would be well advised to study annuity design and marketing techniques. In the next 50 years, the annuity could easily replace traditional forms of whole life insurance as the “bread and butter” product of the industry.

ANNUITIES IN RETIREMENT PLANNING

The popularity of annuities is well established. Their use inside a retirement plan, however, is a hotly debated issue.

In one pending case, five insurance companies are being sued for selling annuities inside retirement plans. The suit charges that this practice extracts extra fees without offering additional benefits because retirement plans are themselves tax shelters. Other problems have developed where agents ***sold*** the tax-deferral of advantage of the annuity knowing full well it was intended for a qualified retirement plan. Agents have been heard telling clients that an annuity is better for their IRA because it was tax-deferred.

Regulators, too, are questioning the use of annuities inside qualified retirement plans. Recently, the ***National Association of Securities Dealers*** notified all brokers, financial planners and insurance agents who recommend annuities for 401(k) plans and rollover IRAs that they should ***disclose*** to clients that the ***tax-deferred feature is unnecessary***.

Industry proponents say that using an annuity in a qualified retirement plan is the only way to assure a participant of the right to a guaranteed stream of income when he or she elects to receive a series of monthly payments (an option known as annuitizing). But that’s not so. Anyone can buy an immediate-pay annuity, arranging for monthly checks for life or for a specified period, such as 20 years.

Others argue that annuities represent a secure, reasonable approach to ***safe-money investing***. As long as the rate of interest is as good or better than a CD, it is an appropriate investment . . . inside or outside a retirement plan.

What is the answer here? We are not sure. At a minimum, a disclosure that the tax deferral nature of annuities is not going to be an advantage inside an annuity and that fees may reduce

the potential yield is warranted when suggesting an annuity for a qualified plan or IRA/Keogh. Suitability for the client and diversification are yet another matter to be watched.

Qualified Plans and Annuities / Defined Benefit - Defined Contribution

Many employers allow their employees to contribute to an annuity inside their retirement plan. Under these **qualified** plans, a person's current taxable salary is reduced and invested in a multitude of investments, including fixed or variable annuities, i.e., these annuities are purchased using **before tax dollars**. If a person owns a small business, he can also invest in a qualified annuity by setting up a Simplified Employee Pension (SEP), a Keogh or a 401k and invest the funds in annuities. Benefits from qualified plans vary widely, taking the shape of defined benefits or a percentage of the account value (defined contribution), and are subject to required minimum distributions (starting at age 70.5), which are fully taxable, as well as a 10% penalty if withdrawn before age 59.5.

Non-qualified or privately purchased annuities can also be used in a retirement strategy since they are generally safe, provide tax advantages when accumulating and can provide guaranteed income for a specified period of time, like a **defined benefit pension**. Or, provide a payout at retirement based on the value of the account, much like a **defined contribution plan**. The path chosen is typically determined when the annuity owner retires and is based on their lifestyle and other revenue sources they may receive from investments, Social Security, IRAs and other qualified retirement plans from previous employers or self-employment.

Benefit amounts from non-qualified annuities are taxed on their earnings when withdrawn. The amount received is based on account balances and the client's needs at that time. Some non-qualified annuity owners may seek the comfort of their annuity paying them a check a month for life, while others might decide to leave the balance intact . . . keeping it available for major emergencies . . . and withdraw interest in bits and pieces or at a set amount each month. Still others can decide that BOTH are the way to go and choose to annuitize a portion of their account while leaving the rest as an emergency fund.

Indeed, annuities offer great flexibility in retirement whether in qualified or non-qualified environments.



PART VII: Uses of Annuities

TAX DEFERRED COMPOUNDING

Compound versus Simple Interest

Simple interest is the interest that is derived from only the investment in a principal amount. Say we take \$100,000 and put it in an investment for one year at a simple interest rate of 5%. We multiply the interest rate of 5% times the principal amount of \$100,000 to derive an interest payment of \$5,000. This seems fairly obvious and straightforward. You give someone \$100,000 for a year, they pay you back your \$100,000 plus another \$5,000. But let's think about what happens in the second year if the interest is not paid out.

In a **compound interest** investment, the interest is not paid out to the holder, it is built up within the investment. Consider our \$100,000 above. If the interest was paid out after the first year, we would get our \$5,000 in interest and have our original \$100,000 still invested. If the interest is not paid out, however, we would have our original principal of \$100,000 plus \$5,000 in interest for a total of \$105,000 at the end of the first year. This entire amount would bear the original interest rate of 5% for the second year. Not only would we get 5% or \$5,000 in interest on the original principal of \$100,000, we would also get \$250 which is 5% on the \$5,000 interest from the first year. Our total interest received would be \$5,250.

This would continue into the third year. At the end of the second year, since we have not paid out any interest, we would start with our \$105,000 from the end of the first year plus the \$250 we earned in the second year. This would give us a third year opening balance of \$110,250 which would bear interest of 5% for the third year. Our 5% interest on \$110,250 equals \$5,512.50. Assuming we still don't pay out any interest, we will now have a total investment of \$115,762.50.

Our example shows us how we generate "compound" interest. We would expect that three years of simple interest at 5% should equal \$15,000 which would combine with our principal amount of \$100,000 to give us \$115,000. The reason we now have an extra \$762.50 is the "compound interest" we have earned on our interest reinvested.

Tax-Deferred v. Taxable Income

According to taxgaga.com the wise way to invest is to keep taxes in the back of your mind so when it comes time to pay them, you don't kick yourself for ignoring them.

On taxable investments, a gain is treated like regular income that is taxable up to 39.6%. A good example would be actively traded mutual funds that produce short-term gains.

The tax-deferred investments are those you don't have to pay tax on right away, things like 401(k) plans and annuities. With these plans, you can let your money appreciate over time tax deferred. You pay taxes on it when you take it out. Another example is the nondeductible IRA under which you can add up to \$3000 each year tax deferred until you make a withdrawal, then it's considered regular income.

Tax-free investments include certain types of bonds or investments made through a Roth IRA accounts from which the withdrawals are completely tax-free as long as you turn 59 years old. You can withdraw even before that as long as withdrawals are of the money you put into the accounts, not the money that has appreciated over the years. Another good investment is buying a home that you can stay in for two years out of the five years prior to the sale of the house by you. That way when you sell the house, the gains you can make off it are all tax-free.

The Difference Between Taxable and Tax-Deferred

A **taxable investment** is one in which you pay taxes every year on the interest, dividends and appreciation of investments that you sell. A simple example of a taxable investment is a regular savings account. Every year when you file your tax return, you're required to report the interest your savings account has earned and pay taxes on it.

A **tax-deferred investment** is one in which you do not have to pay taxes on the investment's earnings until you withdraw money from the account. Examples of tax-deferred investments include annuities, 401(k), 403(b), and IRA accounts. In some cases, contributions you make to tax-deferred accounts are partially, if not completely, tax deductible. Because tax-deferred accounts are designed to help people save for specific goals - such as retirement or a child's education - there are hefty penalties attached to withdrawing your money from the account too soon.

A **tax-free (or tax-exempt) investment** is one in which you don't have to pay taxes on the income the investment earns. A municipal bond is an example of a tax-free investment. Note however, that just because an investment is called "tax-free" does not mean that you won't have to pay any taxes on it. Some tax-free investments are exempt from only federal income taxes, while others may be exempt from only state or local taxes. Also, because investments are tax-free they do not necessarily pay equivalent or competitive rates of interest. In a given market where bank CDs are returning 5%, for example, tax free bonds may offer only 3% or 4%.

Computing Taxable Income v. Tax-Deferred Income

Clients who place their hard-earned money in your hands typically want to know how much it will grow and how long it will take to get there. The **Rule of 72** is a simple formula that has convinced many investors there is power in time and interest. The rule is an easy way to show how long one dollar will grow into two dollars; or how long it will take for \$25,000 to become \$50,000. The equation is simple: Take a projected rate of interest from an investment and divide it into the number 72. The result is the number of years it will take for a specified sum of money to double with **no tax or deferred tax**.

Example: Frita is considering a \$100,000 fixed annuity with a projected interest rate of 5%. How long will it take for her investment to double? Take 72 and divide it by 5 to get a total of 14.4 years. So, in a little more than 14 years, her \$100,000 investment earning 5% will grow to \$200,000. If she was lucky enough to get 9%, the same investment would double in eight years!

The Rule of 72 is also an easy way to demonstrate that there are few shortcuts to a safe accumulation of a nest egg or retirement fund. When you can quickly compute that it takes a rate of 9% to double an investor's money in 9 years, you would immediately know that someone else who promises to double their money in 4 years is suggesting a return of 18%! Of course, this is a bright red flag that should be heeded because few safe, or reasonable investments return 18% in the current market.

A quick method of estimating and demonstrating taxable investing is the **Rule of 108**. To calculate the amount of time it will take for a taxable account to double, use the Rule of 108 (which works by assuming a 33% tax rate). Divide the number 108 by the annual growth rate of the investment. The result tells you how many years it might take for that investment to double, assuming a constant rate of return.

Example: Harry has \$100,000 to invest. You indicate that a yield of 5 percent is available. Assuming Harry is in the 33% tax bracket, you then divide 108 by 5 to find out it will take him 21.6 years to double his money **after taxes**.

The point of recommending tax-deferred investments is it takes less time for tax-deferred accounts to double than it does for taxable accounts when they are invested at the same rate. For example, if you put a client's \$100,000 in a **tax-deferred** annuity, it would become \$200,000 in 14.4 years, assuming a constant growth rate of 5%. But it will take 21.6 years for that \$100,000 to double in a **taxable** account (assuming a 33% tax bracket) at that same 5% annual return. Of course, when the client finally withdraws his money, the tax-deferred annuity will result in taxable income. Before this happens, however, your client's money has grown significantly faster in tax-deferred status. Further, clients are typically in higher tax brackets when they are accumulating funds and in lower brackets when they withdraw them. A recent Price Waterhouse analysis, for example, showed the average annuity contract holder was in a 28 percent marginal tax bracket during accumulation and a 15 percent tax bracket during distribution.

Tax-Free Income

Computing totally tax-free income is the same as computing tax-deferred income . . . use the Rule of 72 to learn how long it will take for your client's money to double. When the investment matures, however, a totally tax-free income will not require additional tax to be paid at withdrawal. The offset to this is the fact that tax-free interest is typically lower than tax-deferred or tax-deferred rates. Further, the client may exempt from federal tax, but not state tax or vice versa. Also, there may be more risk associated, as in the case of bonds where principal can be lost. A complete analysis and comparison must be made to truly understand which is better.

Long-Term Investing

Annuities are mostly long-term investments that should be marketed as such. Agents need to advise clients of this and at the same time stress the advantages of long term investing. Knowing how time and interest effect the long-term is critical to your cause. The Rule of 72 and the Rule of 108 can be very helpful.

Again, it is important to stress that annuities are long-term savings plans. They are a somewhat unique financial planning tool that can offer a variety of payout options, including a secure and steady stream of income clients cannot outlive. Consumers who have purchased an annuity say it is an important source of their retirement security, preventing them from becoming a financial burden on their families.

INCOME DISTRIBUTIONS

As you know, annuities have two distinct phases: (1) the accumulation (or investment phase), and (2) the distribution phase.

The accumulation (or investment) phase is the time period when clients add money to the annuity. The distribution phase is when clients begin receiving distributions from the annuity. There are many options to explore here:

Split Annuity

A "split annuity" is an arrangement in which one payment buys two annuities: a single premium immediate income (SPII) contract, to provide level income payments for a fixed period – usually 5 or 10 years – and a single premium deferred annuity (SPDA), to accumulate cash value at interest. Can you see how this product can function well for retirement planning? Under most split annuity arrangements, the value of the SPDA equals the total premium originally paid for both annuities by the time the SPII income payments stop

Example: Dave invests \$100,000 in a split annuity program. Half or \$50,000 you place is an immediate annuity with an annual income of \$6,500 for the next ten years. The remaining \$50,000 goes into a fixed tax deferred annuity that will grow to \$100,000 during the same ten years.

One advantage of a split annuity is that the original principal is restored at the end of the guaranteed period. This allows a client to start the process over again at prevailing interest rates. The funds placed in the Single Premium Deferred Annuity policy are available for emergencies with limitations.

Settlement Options

There are many settlement options offered by annuities. Clients must select an option prior to annuitization. They can receive the income stream for their lifetime (no matter how long they live), or they can receive the income stream for a specified time period (e.g., ten years). They can also elect to receive the annuity payments over their lifetime and the lifetime of another person (called a "joint and survivor annuity"). Or, clients can simply demand a cash refund or lump sum. Let's discuss these options:

Lifetime Distributions

Under the life option, a client will continue to receive checks until the death of the annuitant. When the annuitant passes, the balance of the client's account goes back to the insurance company . . . not to the heirs of the owner.

Example: At 65 years old, Arthur purchases an immediate straight life annuity for \$1 million and elects to receive monthly periodic payments. His monthly payments are likely to be between \$8,000 and \$10,000 monthly. If he should die after receiving only one \$8,000 income payment, no other payments would be made to anyone else, and his annuity premium would become a part of the insurer's general assets.

Listing a beneficiary as a coannuitant (if permitted) will prevent the insurer from getting the account and extend the payment period as would opting for a period certain, say for 10 years. Of course, the goal here is to select an annuitant that will live a long time.

Keep in mind that in any lifetime option, the amount paid is determined differently based on life expectancy. A 75-year old client will receive more money each months than a 50-year old who is annuitizing the same amount simply because the 50-year old has a much longer life

expectancy. As a general rule, the longer the insurer's potential payment, the lower the rate of payment offered.

Joint and Last Survivor

A married couple would most likely choose this option since it allows support to continue when one is gone. Under this type of plan, checks simply continue after the first death. When the survivor dies, the balance of the account reverts to the insurer. Some contracts pay a slightly lower payment to the surviving spouse or joint beneficiary. However, this is a good way for a husband and wife to be sure that both will receive a lifetime income.

Period Certain

It is not unusual that a client would want at least a minimum payout from his annuity contract no matter who died and how soon. That is the purpose of the period certain option. Checks will continue even after an annuitant dies, until a certain period ends. It is important to note that the period of certainty does not begin when the annuitant dies. It is measured from the date of the original annuitization. So, if a client chooses a ten-year period certain option and dies in year six, payments will continue for another four years.

Cash Refunds

Here, payments are made for as long as the annuitant lives. When he or she dies, payments cease unless total benefit payments made are less than the cost of the annuity. In that event, a lump sum payment will be made by the insurer to make up the difference. This option can help with estate liquidity.

Example: Sharon paid \$100,000 for an immediate cash refund annuity and died after receiving a total of \$25,000 in periodic payments, a payment of \$75,000 would be made to his or her beneficiary.

Annuitization Options Discussed

For any distribution, it is important to understand that the amount received for each payment period will depend on how much money they have in the annuity, how earnings are credited to their account (whether fixed or variable), and the age at which they begin the annuitization phase. The length of the distribution period will also affect much is received. If they are 65 years old and elect to receive annuity distributions over an entire lifetime, the amount they will receive with each payment will be less than if they had elected to receive annuity distributions over five years.

As discussed above, a lifetime settlement will guarantee that benefits are paid through the life of an individual but provide nothing for survivor's upon his death. A joint and survivor option seems to correct this event where payments will continue after the death of the first individual. The downside here is that joint and survivor payments are likely to be less than lifetime payments. This is also the case with period certain and cash refund plans . . . payments continue but they are likely to be lower overall than life only choices.

Some clients use annuitized payments to supplement their living expenses, medical costs, long term care expenses (certain annuity payments may disqualify clients for Medicaid or Medi-Cal), long term care insurance or to buy life insurance to fund a large boost to the estate upon death.

Given the many advantages listed in favor of annuitization, what is the reason that a relatively small number of contract owners choose it. Possible explanations include low interest rates paid on annuitization, fear of inflation on long term payments, a desire for more liquidity and ignorance of annuitization benefits.

Annuitization and Taxes

For ***non-qualified annuities***, the taxation in the accumulation phase is governed in accordance with Section 72 of the Internal Revenue Code . . . all assets invested in an annuity earn interest on a tax-deferred basis. The cash value is allowed to accumulate free of current income tax. This deferral has two advantages: Since more money stays in the account, it builds more quickly than if it were taxed. Also, many policyholders receive their annuity distributions after they retire, when their marginal tax rate may be lower.

In the annuitization phase, there are some additional tax advantages. Each annuitized payment represents a combination of earnings and return of principal. Only the earnings portion is taxable. This contrasts with an early withdrawal from an annuity where the amount withdrawn is distributed as earnings first and therefore are 100% taxable at ordinary income tax rates until earnings are depleted. In addition, there may be a 10 percent IRS tax penalty for withdrawals made prior to 59.5 years of age.

Qualified plans are taxed differently at annuitization because, in most cases, the funds used to contribute to the annuity during the accumulation phase were never taxed. So, at annuitization they are subject to tax at ordinary income tax rates. The offset to this is the fact that by annuitizing, the client can have an income for life or for certain period without the risk he might have if invested in a mutual fund.

ADVANTAGES AND DISADVANTAGES OF ANNUITIES

Advantages

Tax deferral. Dollars can grow tax-deferred until the client starts withdrawals. They do pay ordinary income taxes on your earnings then, but the difference may be profitable—since they may be in a lower tax bracket in retirement. (Think long-term, though, because early withdrawals bring penalties.)

Payout choice. When clients are ready to withdraw money, they'll have many choices: Lifetime payments; payments for a period of time; or payments of certain amounts are just some examples. They may also be able to have the annuity continue paying your spouse if you die.

Systematic withdrawal. Choose between monthly, quarterly, semi-annual, or annual distributions.

Safety. With fixed annuities, the insurer guarantees principal. With variable annuities, the beneficiary is provided a guaranteed death benefit or contract value, whichever is greater

Professional management. Experienced managers run the portfolios that invest payments.

Diversification. With a variable annuity, clients choose between several portfolios. And they can re-allocate from time to time without incurring a taxable event. Diversification among fixed contracts is also available by spreading investment over several insurers.

Avoids probate. Your client beneficiaries get the money immediately because annuities avoid probate. That saves time, money, and legal hassles.

Guaranteed death benefit. Principal is guaranteed in fixed contracts and almost always in a variable contracts.

Enhanced death benefit. Some variable contracts allow an owner to pay more for his beneficiaries to receive as much as 200 percent of his original investment back if he dies prematurely.

Guaranteed income. An annuity can provide your client with a guaranteed lifetime income, regardless of how long he or she lives. No other investment instrument can provide this guarantee.

Unlimited contributions. Unlike other tax-advantaged investments, such as IRAs, clients can contribute an unlimited amount of money to an annuity during the year, whether in periodic installments or a lump sum. Individual carriers may place a ceiling on the total amount they may put into an annuity without approval.

Bonus rates. Some annuities award investors with bonuses -- extra interest that further increases your investment -- at the end of your annuity's first year . The bonus increases the annuity's principal on which future interest will be calculated in subsequent years, thus providing a substantial boost to the ultimate value of an annuity fund.

No-penalty rollovers. Company pension or profit-sharing plan payouts may be reinvested without incurring current taxes or penalties.

No initial sales charges ("no load") or annual fees. Annuities are generally no-load, no-fee investments, which means more of your money is actually invested than with investments where some money is used to pay an initial or annual charge.

Shelter investment earnings. Retired people can use annuities to shelter investment earnings that would otherwise lead to taxation of Social Security benefits.

Tax-free exchange. A client sometimes thinks he wants one thing only to discover later that he wants another. One advantage of annuities is that clients can be exchange one for another tax free using a 1035 exchange. However, early withdrawal or surrender charges levied by the insurer may still be charged.

Disadvantages

Loss of principal. If your client selects a variable annuity, he can lose money.

Expenses vary and can be high.

Earnings are taxed as income once they withdraw them.

IRS Penalties. If clients withdraw money before you're 59 ½, the IRS usually requires them to pay a 10% penalty in addition to the income tax

Surrender penalty. Most contracts have a fee if the contract is surrendered within the first five to 10 years. This is because the insurance company paid a commission to the person who sold the annuity. The more the agent was paid, the longer and more punishing the surrender penalty. However, there are a few products, although not commonly offered, that don't pay commissions and thus don't have surrender penalties.

No capital-gain treatment. All income generated from gains in an annuity is treated as ordinary income. Investments purchased after 2000 and held for at least five years are subject to an 18 percent ordinary income tax rate. In fact, clients are converting potential capital-gain taxation for ordinary income. This is the primary reason to look into current and projected future tax rates before buying.

Loss of step-up in basis at death. Current estate tax laws allow for stock or mutual fund investments passed on to beneficiaries to be valued at the owner's date of death, which is called a step-up in basis. Annuities do not have this feature, and all gains are treated as ordinary income.

Mortality and expense charges: Annuities have, on average, an annual 1.3 percent charge against the assets plus a \$27 annual administration charge for what is termed "mortality and expense charges." This is in addition to the underlying investment fund charges.

Variable annuities have a finite sub-account fund selection.

Loss of Tax Advantage. Tax deferral is lost inside a qualified plan.

Annuity Owners Under 60 Years

Potential annuity owners under 60 years generally have more time on their side to make the tax-deferral advantage of annuities work for them. For example, a \$100,000 contract earning 6 percent can double in 12 years without tax versus 18 years with tax along the way. The effects are even more dramatic with more time.

Younger annuity owners can also be subject to an IRS penalty of 10% on funds withdrawn from an annuity prior to age 59.5. Penalties are waived in the case of death or by choosing to annuitize the contract.

Contract owners under 60 who need some or all their investment back sooner than they planned might also be paying tax on their earnings at a higher rate. Why? It is well known that younger people are in higher tax brackets than when they retire. Needing money prior to retirement, therefore, will most likely mean they are going to pay tax based on a higher tax bracket than is they waited until after retirement.

Younger contract owners who wish to receive an income for life (annuitize) are likely to receive a lower monthly payment than would someone over 60 because annuitization rates are based on life expectancy and the longer someone is expected to live, the lower his annuity payment will be.

Younger owners needing money before retirement will also be subject to surrender charges that may substantially reduce overall yield.

Annuity Owners Over 60 Years

A contract owner over 60 years of age has ***less time*** for the tax-deferred growth of an annuity to work for him. Also, he is ***closer to the age when he may need his income*** from his annuity to cover retirement expenses or medical costs which may require him withdrawing monies from his account early and paying tax as well as ***surrender penalties***. In essence, annuities are long-term investments that may not always fit with the needs of seniors.

Older annuity owners are not subject to an IRS penalty of 10% on funds withdrawn from an annuity prior to age 59.5. This helps in the event funds are needed earlier than anticipated. But, early withdrawals are subject to surrender charges which can substantially reduce overall yield.

Contract owners over 60 are more likely to reap tax advantages from annuities they have held for sometime since their earnings will likely be taxed at lower tax rates. Why? It is well known that younger people are in higher tax brackets than when they retire.

Older contract owners who wish to receive an income for life (annuitize) are likely to receive a higher monthly payment than would someone under 60 because annuitization rates are based on life expectancy and the longer someone is expected to live, the lower his annuity payment will be. This is offset by the fact that an owner who annuitizes at age 70 may only live to age 75. If he chose a life annuity option, his payout is substantially diminished over another owner who lives to be age 90.

Older annuity owners may face ***forced annuitization*** . . . even at times when they are least likely to want it or afford the tax . . . where an insurer sets a specific age that requires payouts to start. For qualified plans, this age would be age 70.5. Non-qualified contracts may extend this limit by many years.

Annuities and Other Investments

To know exactly if an annuity was appropriate for your client you would need to know everything about their existing and future cash needs, long term planning and exactly when they plan to die. Even without this information, it is probable that some form of annuity investing can be considered suitable for your client's financial planning at some point in their lives . . . especially when balanced with other investment mediums.

Annuities are first and foremost a long-term investment for someone in the moderate to high tax brackets looking for a way to shelter current income or growth. For investors who do not need to get at their money too often, annuities would make a smart alternative to bank CDs or mutual funds.

To a great extent it comes down to the level of risk a client is willing to take. Some clients are risk takers, others are conservative or moderate. Within each of these categories there is an annuity and as well as some form of alternative investment that could meet a client needs. Also to be considered is that some people need current income, others are looking for long-term accumulation or growth. Still others need current income but some means to offset inflation over the long haul. It would be rare to find annuities solving all these requirements. However, they certainly have their place in a client's personal financial planning.

Bank CDs, Savings or Money Market Accounts

A bank CD, savings or money market account is a proper choice for seniors wishing to limit their risk and enjoy consistent returns. Their obvious advantage over annuities is a shorter maturity and in the case of bank CDs federal guarantees (FDIC insurance) against loss of principal. Their disadvantage, however, is that all earnings are currently taxable and rates are often lower than those offered in annuity contracts. Shorter maturity CD's somewhat address the inflation problem since rates float up and down) as the market dictates. A fixed annuity contract, on the other hand, requires a lock-in of many years with little chance to offset inflation factors.

Mutual Funds, Stocks, Bonds, Commodities/Options

These investments are at the other end of the investing spectrum . . . higher risk, but potentially higher returns and inflation adjustment. There is also the opportunity among these vehicles to select both conservative and tax advantaged choices to rival almost any annuity contract. On the other hand, with a variable annuity contracts, there is the ability to participate in both -- a somewhat predictable return and tax advantages!

The key difference as to an individual investor's choice is probably his willingness to take risks and his need for liquidity. Since no one knows when an emergency might hit, the liquidity of mutual funds and stocks would fare as a slightly better choice. On the other hand, if long-term stability with tax advantages is the signal, the scales tip more toward the annuity.

Limited Partnerships, Notes, REITs and Viatical Settlements

These types of investing are for only the strongest of investors. Liquidity could be zero in bad times and principal is continually at risk but returns are potentially the highest. There is simply no guarantee. There is practically no suitability in these products fitting the financial plan of a senior citizen other than for the only the well-heeled.

Mixing It Up

A common sense approach for many clients may be to diversify among many product investments to meet goals and suitability requirements. For the very conservative, a cross section of fixed annuities, CDs and even low-risk mutual funds could be appropriate. A more moderate approach might shift more toward the mutual fund and light stock arena while an aggressive plan may reduce annuities and CDs to a minimal position in order to emphasize growth mutuals and stocks with a some real estate thrown in for inflation.



PART VIII: The Senior Market

SENIORS AND RISK

Of all the market groups you will face, seniors have the least capacity to accept risk. It is true that seniors control a good portion of our nation's wealth. But it is also true that if lost, they do not have the time to make it again.

Think about it. An unsuspecting senior client who buys \$200,000 of unsuitable variable annuities from you is hurt a lot more than someone who buys a fake Rolex for \$20 on the street corner. Both are ethical infractions, but the loss to a senior can be devastating beyond comprehension.

As an ethical agent it is your job to determine your senior client's exposure to loss and his ability to accept it. The attentive professional will glean invaluable information and respond to his clients' fears, which can run the gamut from taxation worries to running out of money to long-term care planning.

Addressing these concerns while taking seniors' unique needs into account is meaningful and in some cases a new legal requirement (see Part IX).

PRE-RETIREMENT VS. POST RETIREMENT PLANNING

Prior to retirement a client's goals and objectives should be assessed. This process should begin in earnest at age 40 or sooner. The underlying emphasis here is to determine the following:

- Learn about retirement plan funding methods.
- Determine an appropriate contribution level for your employee savings plan.
- Develop strategies to accumulate assets.
- Use methods to reduce taxes.
- Formulate an asset allocation strategy.
- Reviewing wills and other legal documents.

The agent's role can be the suggestion of suitable product to achieve these goals along with appropriate referrals to outside professionals where needed. Annuities with growth potential have more application at this phase.

When a client is ***closer to retirement***, the planning process notches up to include the following:

- Making sure your goals are realistic.
- Repositioning your assets and benefits.
- Analyzing available retirement income funding methods.
- Identifying alternatives to continue the growth of your assets while producing income and minimizing taxes.
- Confer with a team of financial advisors.

Again, the agent enters to position or re-position appropriate and suitable product.

Post-retirement planning doesn't end when the client stops working. Why? Because he must continue to maximize his income, refine goals, minimize taxes and penalties for premature distributions, excess distribution and underestimated withdrawals beginning at age 70 ½, organize assets, prepare for proper estate planning, determine appropriate housing and determine and identify any major purchases to be made.

Clients will look to you to again re-position product and refer to outside professionals in an appropriate and suitable manner. Annuity rollovers, exchanges and annuitization are typical topics of discussion.

Variables to Consider

For adequate retirement planning it is necessary to consider a number of variables that can effect savings, spending and lifestyle of the future. You should consider your client's **time horizon** until retirement and considering the number of years left during the retirement years. Remember, people are living longer and longer, current lifestyle and future desired lifestyle, spending money now and how to spend it in the future, resources available now and in the future including personal savings, employer benefits, social security and inheritance, if any, taxes now and later. Will tax rates go up or come down? As this issue is not predictable it is best to plan for the worst case scenario, inflation rates now and later and investment returns for your investments. Consider diversification and asset allocation for well-rounded portfolio results.

FINANCIAL CONCERNS

Seniors have more to worry about than where travel nest or the next golf tee time. Their financial concerns are the same as anybody with the added burden that they could outlive their income by spending through their assets. The foundation of their world focuses on their financial staples: Social Security, retirement plan distributions and investing retirement assets.

Social Security

In general, an individual is entitled to a retirement benefit if he or she: (1) is fully insured (worked an adequate number of quarters), 2) is at least age 62 throughout the first month of entitlement, and (3) has filed application for retirement benefits.

Age 62 is the earliest age that a retired worker who is fully insured can start to receive retirement benefits. The retirement age when unreduced benefits are available (presently age 65) will increase by two months a year for workers reaching age 62 in 2000-2005; will be age 66 for workers reaching age 62 in 2006-2016; will increase by two months a year for workers reaching age 62 in 2017-2022; and will be age 67 for workers reaching age 62 after 2022 (i.e. reaching age 67 in 2027).

Amount of a Retirement Benefit

A retirement benefit that starts at Normal Retirement Age equals the worker's PIA (primary insurance amount). But a worker who elects to have benefits start before Normal Retirement

Age will receive a monthly benefit to only a percentage of the PIA. As a general rule, a person taking reduced retirement benefits before Normal Retirement Age will continue to receive a reduced rate after Normal Retirement Age.

You should also note that a person is entitled to retirement benefits regardless of how wealthy he is. Also, the amount of retirement income a person receives (e.g. dividends, interest, rents, etc.) is immaterial. A person is subject to loss of benefits only because of excess earnings arising from his personal services.

Survivor's Benefits

Benefits payable to the survivors of a deceased insured worker include mother's or father's benefits with children, surviving spouse of an insured worker, child of a deceased worker, widow(er)'s benefits and a lump sum death benefit of \$255.

Social Security Cutbacks

Social Security and Medicare is paid on a "pay as you go basis". Unfortunately, the ratio of the working age population (ages 20-64) to the retired age population (ages 65 and over) will decline from the current level of 4.7 workers per retiree to 2.8 workers per retiree by the year 2030, when most of the baby boomers will have retired. To finance the same retirement benefits on a pay as you go basis, active participants would have to pay about 67% more in Social Security taxes in 2030.

The baby boomers probably will feel a large crunch from the reduction in Social Security and Medicare benefits. Take for example, a person who is now age 45, earning \$61,200 annually, and wishing to retire at age 67. To cover a 10% reduction in Social Security benefits will require an additional \$63,000 at retirement.

Retirement Plan Distributions

Prior to age 70 1/2 clients do not need to take money out of their retirement accounts—though your employer's plan might require them to do so. In fact, there will usually be a 10% early-withdrawal penalty if they make withdrawals from an IRA before age 59-1/2. Between the ages of 59-1/2 and 70-1/2 they pay only the income tax on any amounts they decide to withdraw, with no tax on the return of after-tax contributions made.

Once you hit 70 1/2, withdrawals must begin. Technically they can be postponed until April 1 of the year following the year they reach 70 1/2--say April 1, 2005 if they reach 70 1/2 in 2004. But waiting until April 1 means they must withdraw for two years—2004 and 2005—in 2005. To avoid this income bunching and a possible higher marginal tax rate, tax advisers generally suggest withdrawing in the year seniors reach 70 1/2.

IRS has greatly simplified and relaxed the withdrawal rules, effective for 2003 and after. The thrust of the changes is to increase the retirement plan tax shelter, by lengthening, in most cases, the period over which plan withdrawals may be stretched.

The rules now allow clients to automatically spread withdrawals over a period substantially longer than their life expectancy. Under these rules the taxpayer (say, an IRA owner) first determines his or her retirement plan asset values as of the end of the preceding year. Then the

owner takes the number for his or her age from an IRS table (the table is unisex). The number corresponds to the period over which the withdrawals may be spread. The owner divides that number into the retirement asset total. The result is the amount to be withdrawn for the year.

Example: Mike reaches age 70 1/2 this year. Retirement plan assets in his IRA totaled \$600,000 at the end of last year. The IRS number for age 70 is 27.4. Mike must withdraw \$21,898 ($\$600,000/27.4$) this year. When Mike is 72 his IRA is \$602,000 at the end of the preceeding year (age 71). The IRS number for age 72 is 25.6. Mike must withdraw \$23,517.

Under the current rules, the life expectancy of a designated beneficiary (if any) is irrelevant in figuring the withdrawal period (except for a beneficiary spouse more than 10 years younger). Thus, clients can change their designated beneficiary at will, or replace one who died, without affecting the withdrawal period (except for a change to or from a spouse more than 10 years younger).

You can advise clients that they can always take out money faster than required--and pay tax on these withdrawals. However, the tax code is strict about minimum withdrawals. If they—or your beneficiaries or heirs—fail to take out what's required, a tax penalty will take 50% of what should have been withdrawn.

Investing Retirement Assets

At retirement age, a senior's attention shifts to retaining principal, maximizing income and minimizing taxes. This is not the time to suggest an aggressive variable annuity with a long surrender time line because a senior may need to get at their money at any given moment for a major medical emergency or chronic illness not covered by Medicare or a health plan.

As important as a senior liquidity investing is, it is not as important as safety of principal. After all, seniors do not have time to make it over again. Diversification and prudent company choices is the bare minimum you must provide.

INSURANCE CONCERNS

The needs of mature market groups is far more complex than those of younger generations. Instead of simply covering an economic loss of a breadwinner, insurance and annuities may play a critical role in a client's planning of his estate, business, investments, retirement, tax reduction, long term care and more! For the agent, this means a working understanding is needed for a wide variety of insurance products; including how they function, their specific role in helping mature markets and various implications concerning taxation and eligibility.

For instance, if you are recommending a client surrender an annuity contract he already owns and use the proceeds to buy Medigap or long term care insurance, you need to know and/or advise the client that the transaction may generate some taxable income and possible surrender charges. The taxes he must pay may reduce the amount he has available to buy the coverage you recommend. In another example, your recommendation to take a lump sum from one area might limit or exclude a client from eligibility and/or basic needs in another. Clients need to understand this may happen in order to make prudent decisions.

Health

The senior health continuum suggests that you monitor your clients to determine their specific and changing needs. For instance, let's say you have been helping Doctor Smith with his disability insurance needs for 10 years. As he nears retirement, it becomes your responsibility to suggest the idea of phasing out his disability program and using the same funds to buy a long term care policy or annuity contract.

Medicare

A good portion of your discussions with clients will involve Medicare. Agents who work in the mature market must fully understand this area in order to explain benefits as well as what clients cannot expect it to cover. And, if you are offering a senior HMO as an alternative, you must be able to make accurate and realistic comparisons.

Medicare hospital insurance helps pay for medically necessary care in a Medicare-approved hospital, skilled nursing facility, and hospice. It is very important to understand the distinction that a skilled nursing facility care is not the same as custodial nursing home care.

Skilled nursing care is acute care, while custodial is long-term care. Most nursing homes in the United States are not skilled nursing facilities, and many skilled nursing facilities are not certified by Medicare. So in conclusion, Medicare will provide for less than 2% of a client's long-term care health payments. Medicare will, however, provide payment for health care for individuals over the age of 65 and certain individuals under the age of 65 with significant disabilities. So, Medicare is basically a health insurance program for senior citizens. The benefits available under Medicare are similar to those under most health insurance plans in the way they lack substantial or even modest levels of long-term care.

Medicare does not usually pay for nursing home costs, but the federal Medicare Catastrophic Coverage Act (MECCA), enacted in 1988, adds confusion, since it allows Medicare to pay for a limited amount of nursing home costs that previously were, for the most part, paid by Medicaid. However, these benefits were only for patients who qualified for welfare benefits, since such long-term care costs were not deemed to be medically necessary.

Medicare only pays for "**Skilled Care in a Nursing Home**" or "**Intermittent Care in a Nursing Home or at Home**". Medicare does NOT pay for intermediate or custodial care, such as that required for Alzheimer's patients. The following table will help put this into perspective:

| BENEFIT | MEDICARE PAYS | CLIENT PAYS |
|-----------------|-------------------------|--------------------|
| First 20 days | 100% of Approved Amount | NOTHING |
| Next 80 Days | All but -\$95.50 / Day | \$95.50 / Day |
| Beyond 100 days | NOTHING | ALL COSTS |

Source: 1997 Guide to Health Insurance for People with Medicare

Senior HMOs

In lieu of Medicare and a Medicare supplement policy, a popular choice is the managed care plans which are often called **HMO's or Coordinated Care Plans**. Most of these plans collect a fixed monthly payment from the government, regardless of the patient's health, and must

promise to cover all patient needs that would have been paid under Medicare. To contain costs, many of these groups contract with specific health care providers and clinics to offer Medicare services. In some cases, managed care groups provide a bit more than Medicare or supplement plans as an incentive to switch. Unlimited prescription drugs and some respite care are a couple of examples that have been used to attract Medicare enrollees. Currently, about 15 percent of the people eligible for Medicare choose managed care plans. Congress is happy about this because the government's monthly commitment is fixed and these private concerns are far better at cost containment than Medicare.

The concept of senior managed care is being tested in some our country on a grand scale. The primary advantage to this type of system is that it is a prepaid health care plan that promotes wellness and preventative medicine.

The predicted effects of managed care tend to offset the advantages of a more traditional comprehensive health care program. Under a managed care program, doctors are salaried, and their earnings are not affected by quantity of care. Therefore, there is no incentive to overtreat patients. As a result, waste and unneeded services are minimized. The purpose of managed care is to promote cost effectiveness of medical services.

It must be emphasized that while senior HMO's offer a few more frills than Medicare, they do not cover long term care. Services such as nursing homes and home health care are excluded for chronic conditions.

In some cases the funding for these needed services come from the clients own pocket. And, planning for these times can be critical. For example, selling a 75-year old, moderate income woman a deferred annuity with a surrender period of 8 years is an unsuitable sale. She will likely need some of this money to provide for medical care not covered by her HMO, Medicare or long term care provider, if any.

Medicaid and Medi-Cal

As big as your job was to explain the Medicare "minefield", you have a bigger job with Medicaid - - Medi-Cal in California. Clients do not understand it AT ALL and most still believe that it will somehow help them if they have a long term care episode.

The fact is, Medicaid is a needs based program providing of long-term care for those who qualify -- mostly the poor and indigent. Even though it provides approximately 45% of the funding for long-term care, qualifying can often be a major problem.

In general, Medicaid pays for hospital, medical, prescription drug and "medically necessary" nursing home care. The Medicaid system was originally intended to be a "safety net". It was established to assist families in crisis and help the medically needy who lacked access to medical care. Above all, it was designed as a **short-term solution** for health care. Use of the system, however, has been far different than was intended. The program now has the stigma of a social welfare program providing current, on-going and long-term health care for families and seniors alike. Combined with our rapidly aging population and the high costs associated with long-term care, it is easy to see why there is great concern.

Medicaid is a **needs based** program (the exact opposite of Medicare). Medicaid provides benefits only to those who demonstrate a financial need. This means that a patient cannot have more than a limited amount of cash or other available assets. States that operate their Medicaid

programs this way are called **Share the Cost** states. Of course, there are exemptions and methods for families to restructure their assets to qualify for Medicaid benefits. This process is called **spenddown**. It is a complicated area, but essential to the understanding of Medicaid and long term care.

Medicaid, can be considered both a companion and competitor of private long-term health care policies. Educating clients about the Medicaid "minefield" can be a very convincing way to motivate them to buy LTC insurance.

SB 483 Kuehl -- Annuities and Medi-Cal

Using annuities to protect assets from the nursing home expense has become very popular. Two recent books on the subject, *The Medicaid Planning Handbook* by Alexander A. Bove, Jr. and *Avoiding the Medicaid Trap* by Armond Buddish, specifically discuss the use of annuities to avoid Medicaid seizure. In fact, a few insurance companies have designed deferred annuity products with features that are implemented at the appropriate time to get around Medicaid rules. Although the Kennedy Kassebaum Bill continues to sanction annuities as a tool in the Medicaid spenddown scenario, there are many potential disasters with using annuities to shield assets. Following are some parameters to remember:

- In California, **SB 483 (2008)** was enacted to bring California into compliance with provisions of the Deficit Reduction Act of 2006 which lengthened the **"look-back" period** for asset transfers to establish Medicaid's eligibility for nursing home coverage from 3 to 5 years, requiring annuities to be disclosed and states to be named a **remainder beneficiary** for the cost of Medicaid assistance with certain specific exceptions. The bill would also deny medi-Cal assistance to anyone who has a **home equity limit** of \$750,000 or more. Then too, the bill allows anyone to demonstrate that the lack of medi-cal assistance would establish an undue **financial hardship exception**.
- The annuity must be annuitized prior to applying for Medicaid. Many consumers who own deferred annuities will not remember that they must annuitize the policy prior to applying for Medicaid. Once the Medicaid applicant reveals that their annuity is a deferred annuity, then it's too late. Medicaid (Social Services) will order the policy owner to either cash in the annuity for spend-down or simply disqualify the applicant for having assets that exceed the qualifying amount.
- If you purchase an annuity for the purpose of protecting your money from nursing home spend down, there is no guarantee that Medicaid will not simply change their qualification rules in order to disqualify such Medicaid applicants. The government is an expert at changing the rules.
- Under the Kennedy Kassebaum and OBRA '93 Act, an annuity must have life expectancy payout rates that are in accord with the latest social security mortality tables. Many insurance companies' payout rates are not compliance.
- Some annuities will not allow you to annuitize the first year. Therefore, if your situation should require annuitization during the first year, you would simply be out of luck! (There are other annuities that will not allow annuitization for 5-15 years.)
- If a deferred annuity is purchased to shield assets against Medicaid, the purchaser will often make a spouse the annuitant, so that in the event of nursing home confinement, the deferred annuity can be annuitized with income going to the spouse. However, if the annuitant predeceases the annuity owner, the death benefit is triggered. In some cases, a surrender charge is charged upon the death of the annuitant. In addition, the owner of the annuity will receive notice from the IRS for the taxable gain, not a pleasant experience. Finally, since the

spouse is usually the primary beneficiary, the proceeds will be made payable to the contingent beneficiary. This is most likely the children and not the owner of the policy. This scenario could cause exercise of your E&O.

- Many purchasers do not understand how Medicaid actually works and therefore are not qualified to engage in this type of planning.
- OBRA 93 established and mandated a 60-month look back for deferred annuities. Many State Medicaid offices use this provision to initiate or trigger the ineligibility penalty period, creating an array of problems that may ultimately be attributable to ownership of a deferred annuity.
- Using an annuitized annuity to shield assets loses its glitter when it comes to single individuals, since the annuitized income cannot be directed to another individual as with married couples and the income stops should the income recipient die.
- What happens when the annuitant simply dies? You cannot attempt to qualify for Medicaid by annuitizing your policy with the intention of passing excessive monies to your heirs. Under the Estate Recovery rules passed by OBRA 93, any income that continues to heirs after your death could be subject to recovery by Medicaid.
- It is worth considering that if you annuitize based on your life expectancy, the interest rate provided by the company may be quite low!
- If the annuity owner has to enter a nursing home because he has become incapacitated or mentally incompetent, who can make the decision to either gift the annuity policy or simply annuitize it? No one can, unless there is a durable power of attorney which grants such power. Even having a durable power of attorney is no guarantee, since many documents do not contain the requisite language for gifting or annuitizing such a policy.
- You cannot use a section 1035 exchange to avoid some of the problems mentioned above (see, for example, items 4), 5), and 6) because this procedure requires that the owner and annuitant in the successor contract remain the same.

Annuity Income and the Medi-cal Threshold

While you are in long term care, you can have income of up to \$35 per month, that is called the "maintenance need standard" which the state sets. If your income is higher than that, you may qualify nonetheless if you agree to pay the medical costs each month until you reach the \$35 threshold, then Medi-Cal will pay the remainder, provided the services are covered. This is known as the share of cost. For example: if Joe enters a skilled nursing facility and his income is \$1,200 per month from Social Security, Joe will have to pay \$1,165 toward the cost of the facility, that will be his share of cost. Joe is entitled to only \$35 of his \$1200 per month Social Security check as his personal needs allowance. It is important to know that **payments from an immediate annuity will be considered "income"** and will have to be used towards share of cost if eligibility is established.

Good Faith and Fair Dealing (Section 785 CIC)

In any dealings with seniors, keep in mind that all insurers, brokers, agents, and others engaged in the transaction of insurance owe a prospective insured who is 65 years of age or older, a duty of honesty, good faith, and fair dealing. This duty is in addition to any other duty, whether express or implied, that may exist.

Long Term Care

Tragically, many consumers have convinced themselves that Medicare, Medigap supplement policies, Medicaid or their HMO will cover long term care. They do not. *Again, people (your clients) need to change their habits or else be forced to rely on welfare or the graces of people willing to take care of them!*

Long term care insurance buyers also need to get over their resistance to the higher cost associated with quality care. People who want quality care need to plan now. The government will simply not provide it. Private insurers can and will. Evidence is the evolution of LTC policies from an era of limited, bare bones coverage, to comprehensive plans complete with alternative care options. This is a higher quality care that comes with a higher price.

Long term care must also be evaluated in light of the LTC medical continuum. Residential care facilities and adult day care, for example, are increasingly covered in today's policies while earlier policies restricted benefit payments to only those facilities that offered Adult Day Care. Another example might be new generation policies that cover home care and special services, without which the insured would require institutional care. Agents need to understand how the policies they offer relate to the Continuum of Care from the standpoint of policy triggers, ADLs, mental deterioration, etc. This can only be accomplished by evaluating individual policies on a case by case basis.

Long term care services might be needed by almost anyone. An accident or sudden serious illness could be the trigger as well as a slow progressive condition like rheumatoid arthritis, Alzheimer's / Parkinsons or cardiovascular disease. Conditions are likely to befall any age and gender although women seem to need them more than men for various reasons.

Long term care services can be purchased with insurance benefits, provided by government entities or paid "out-of-pocket". Some long-term care policies ONLY cover services in a nursing home (intermediate care and skilled care facilities). Newer and more popular plans cover home and community-based service. In some instances, the home and community-based services, which often can help a person avoid going to a nursing home, have limitations. So, be sure to read the policy carefully.

For those unable to purchase LTC insurance, planning may involve finding alternative sources like annuities, reverse mortgages, viatical settlements, etc. For some, these sources may also provide the critical income needed to buy LTC insurance. One strategy, for example involves the decision to annuitize an annuity contract and use the monthly benefit to purchase long term care insurance.

Estate Planning

It takes an entire course to just to begin to understanding this topic. For now, it is important you know that estate planning is a two-phase undertaking. It seeks to maximize, for the estate owner and his or her family, the security and enjoyment flowing from property ownership, both during lifetime and after death.

Insurance and annuities can play a starring role in guaranteeing that cash will be available at death to meet the financial costs of death. The use of life insurance to meet estate liabilities may

prevent the forced sale of prime assets. This, in turn, will reduce the ultimate shrinkage in estate values and perhaps keep alive a source of income for the beneficiaries of the decedent.

SELLING TO SENIORS

Market Volatility and Risk Tolerance of Seniors

The life a senior today is far more complex than he ever dreamed it could be. In their younger years, for example, virtually everyone bought whole life insurance to cover burial costs and/or to build a small pot of money down the road. They started with a small whole life policy and paid on it forever. Things like long term care coverage never existed and annuities had limited application. Senior generations today live with substantially higher liability and lifetime medical limits in response to more lawsuits and escalating hospital bills. Recent **market volatility** has added to senior woes where up to 33% of their retirement stash has been lost. Millions are now seeking safe places to stash what is left.

These factors and more have created the need for specialized and complex products. It is your job as agent to unwind this complexity, make your product suggestions crystal clear and determine a seniors exact **risk tolerance** based on assets and liquidity needs. Above all, you must share the downside potential present in any financial product . . . such as **annuity surrender charges** . . . especially where you are replacing an existing product. Only then can a senior client make an informed decision.

The Senior Continuum

A continuum is something with a continuous structure. Your life is a continuum of events from going to school, to graduating college, to getting married, to getting your insurance license, etc. It is a structure that is constantly changing, yet continuous until you die. Top agents recognize that there is also a **client continuum** within which clients progress through life and lifestyle changes.

Example: You've been helping Doctor Smith with his disability insurance needs for 10 years. As he nears retirement you suggest the idea of phasing out of his disability program and using the same funds to buy a long term care policy. The continuum changes from income replacement needs to coverage for long term care or a lifetime income.

As you can see, the client continuum is in a constant flux as it responds to new terms, new legislation, coverage limitations, underwriting changes, medical breakthroughs and other market-driven demands. Sometimes, agents who have been in the business for many years fall into the trap of failing to hone their skills to keep up with the times. Stay focused and "tune in" to current events. Use this knowledge to provide "cutting edge" service and products to responsibly meet changing client demands.

Buyer Competence

Given the complexity of insurance products it is not hard to see why untrained consumers find them hard to understand. In fact, a U.S. House of Representatives investigation into insurance regulation years ago found serious defects:

- Purchasers do not understand how limited the coverage purchased is.
- Policies seem to be drafted more with an intention of limiting claims than to restricting claims to valid circumstances.
- Policies reflect illusionary benefits.
- Sales presentations are poor in quality and misleading.
- Sales are made to persons who cannot afford to keep the policies in force for more than a few years.
- There is an absence of non-forfeiture values and consequent loss of benefits by most purchasers.
- Policies are marketing with fixed benefits and rising premiums.
- There is inadequate and misleading information about inflation protection.
- There is inappropriate taxation by the federal government
- There is inadequate technical information on solvency standards

When it comes to seniors, the complexity of insurance and annuities takes on new meaning where a **senior's judgement and mental competence** is often reduced or impaired. **Symptoms** you should be aware of include problems remembering recent events, difficulty in following simple directions, **lack of short term memory**, confusion, personality changes, difficulty in finding words or finishing thoughts, disorientation of time and place, inappropriate dress or hygiene, etc.

Recognition of these signs could mean the person you are dealing with does not have the capacity to make an informed and reasonable decision about his financial well-being. It would be ethically wrong to sell to this person. In California, there could also be legal implications since a person entirely without understanding has no power to make a contract of any kind. Further, any contract made is subject to rescission. **(Civil Code 38 and 39)**

What do you do in these cases? Consider additional **family involvement** from children, brothers, sisters, etc. in making annuity investment decisions. A properly executed **power of attorney** is also advised. Of course, such a power must have been executed prior to any loss of competence in order to be valid.

Ethics and Compliance

It is predicted that some of the most highly litigated products in the insurance industry will those sold to seniors and other mature markets. Why? Perhaps some unethical agents are drawn toward policies sold to the elderly because they are often vulnerable to scare tactics and pressure pitches. Also, perhaps the time line of long-term insurance vehicles like annuities and long term care comes in to play. Policies sold today, for example, can and will fail to meet client needs when they need them most because in the time that passes before benefits might be used, there is a lot that can go wrong. This is all the more reason that your clients need to "lean on you" for your advice. You must be knowledgeable in your product, sell only what you understand and be certain it meets the stated needs of your client to the best of your ability.

A proper attitude about this responsibility is not only prudent, but important to your success. No agent can really prosper and move forward if he leaves a trail of dazed and unhappy clients behind. Understanding the mistakes of others and not making them yourself is probably the best way to assure this doesn't happen. You have several ways to evaluate your selling performance, our advice is to let one measure be the problems you avoid in helping clients acquire valuable insurance protection and effective, safe investment opportunities. Likewise, it

does little to build a thriving insurance practice only to have it all taken away from a single lawsuit. When you avoid the legal problems in selling insurance, you are protecting your own future as well. Some of the specific rules you must abide by are included in the next section.

Compliance is crucial, but it is not the same thing as being ethical. In fact, you can still be legal but ethically wrong. Posting a code of ethics or simply doing the right thing most of the time is still not enough . . . although it's a start. You see, having high ethical standards, or more simply being honest, can be more important than being right because honesty reflects character while being right reflects a level of ability. Unfortunately, the insurance industry, for the most part, still rewards ability. There are, for example, plenty of "million dollar" marketing winners and "sales achievement awards"; but few, if any, "Ethics & Due Care" certificates.

You bring a higher level of ethical conduct to your practice just by the manner in which you operate. This includes more **effective communication**. A lot of times, making something easier for your client to understand means you have to sacrifice your ego. Face it, you really want to impress clients with your newfound knowledge about annuity facts and features . . . don't you? It's human nature. But, resist the urge to spout.

Higher ethical standards are raised when you are **needs based**. A needs-driven sales system's analyzes a client's needs and determine how insurance and annuities can best meet those needs. It is not meant to generate the sale based upon the obvious points of the product or the need of the salesperson to produce. It uncovers a prospect's general financial problems or deficiencies so that the prospect begins to recognize the need. The problem is personalized to arouse interest in a possible solution.

Like any system, needs analysis works effectively only when it is used as it is designed. The system builds upon itself in terms of both content and data and is most effective when used from start to finish. Shortcuts undermine the effectiveness of the process. An agent following this system from start to finish can never be accused of less than professional point-of-sale practices.

Needs-based selling goes into great detail in analyzing needs and creating recommendations that are based upon airtight logic and conclusions. Needs-based selling involves the client, allowing him or her to use his or her own ideas and assumptions. It is a process that allows the prospect to participate in creating his or her own solutions to needs based upon what he or she considers important. Analyses must represent and respect the client's opinions. The goals are those of the prospect, not the agent. If the goals are not the goals of the prospect, the prospect is not likely to go along with the agent's recommendations in the end.

The needs-based selling system is characterized by the recognition of accurately assessed needs, which are the result of careful and professional analysis. Through careful fact-finding, information is gathered about the prospect's desire to provide income to family members in the event of premature death or disability, as well as to plan for retirement needs and accumulation. The analysis performed is based upon interest rates, inflation assumptions and the prospect's views about his or her objectives and timetables.

Needs analysis helps the agent sell the right amount of insurance to the client for the right reasons. In today's competitive environment, agents cannot afford the exposure of makeshift or piecemeal sales practices. They must have a complete, comprehensive selling system. They must provide a needs-based analysis for their clients and generate trustworthy

recommendations based on this investigation. Learning how to effectively determine needs gives the opportunity to offer a full array of financial products and services.

This sales system is focused on needs for another reason. In addition to needs being the best reason for a client to buy life insurance, it is also the best reason to sell life insurance. Sales based on greed, i.e., big returns on premium dollars paid, can be made by people other than life insurance agents. A sale based on greed is simply selling a return, or just selling a configuration of numbers on a piece of paper. This type of selling can be done by bankers, stockbrokers or even accountants. Selling based on a genuine need for life insurance is another matter. Needs-based selling is the thing that makes life insurance agents necessary; greed selling is the thing that could make them extinct.

Clients who have needs, also need **solutions**. A responsible agent understands that this starts with matching specific needs of a client to dozens of policy features and benefit options – this is not a job for sissies! When all is said and done, however, a responsible, solutions-based agent must take the final step to assure himself and client that your insurance or planning suggestion is the most effective way to handle economic and health needs. You must sprinkle your client meetings with the following questions:

- Does this make sense to you?
- Have I given you all the information you need to make a decision?
- Is there something else I can answer to assure you that this is the right solution based on your needs?

These are essential questions because they help “clear the air” circulating around any doubts or concerns your client may have. And, they can also help limit your liability if something goes wrong down the road (more ideas on reducing conflicts with clients later).

A positive response to these questions is the feedback you need to know that you have “gotten through” to your client and are providing some real solutions to some very important needs.



PART IX: Selling California Annuities

The line between legal responsibility and agent misconduct can often be very, very thin. Few agents can say they have never gone out on a limb, looked the other way or fudged just a little when selling and serving a client. These indiscretions, hopefully tiny and few in number, usually lead to nothing. But when something goes wrong, an agent's biggest fear comes true . . . a malpractice lawsuit.

The selling of insurance and annuities is complex. There are still many unknown factors about premiums or benefits; the clientele are typically old and forgetful and the proof that you did a good or bad job may not surface for 20 or 30 years; all of which promote the possibility that a lawsuit could land in your lap at anytime, up through your own retirement. That is why agents must practice due care at every moment and through every phase of the annuity sale.

A few ways to minimize conflicts between yourself, clients and your carrier include:

- Select product that is suitable for your client.
- Know the product you are selling, including all reasonably priced and widely available options the policy offers.
- Be sure coverage is adequate at the time of sale.
- Be wary of "special agent relationships" that may define you as a fiduciary to the client.
- Avoid **dual agency** status where you have defined yourself as an "expert" or having special knowledge.
- Develop **standard operating procedures** to handle all clients the same.

Consult an attorney or capable advisor before giving clients advice in areas of taxation, estate planning, asset protection, financial planning, etc.

Let's look at some specific areas of compliance in California:

ADVERTISING

The cornerstone agent ethics is the handling and choice of company, product and sales presentation to best serve a client's financial planning. As it relates to advertising, you should provide sales materials that are clear as to purpose and honest and fair as to content per **Section 1725.5 of the CIC**. This also means prominently affixing your license number, phone and address to any printed material, illustration, price quote or ad. Violations start at \$200 and go as high as \$1,000.

Senior Advertising

California requirements (**CIC 787**) are very specific about advertising directed at seniors (anyone age 65 or older):

No insurer, agent, broker, solicitor, or other person or other entity shall solicit persons age 65 and older in this state for the purchase of disability insurance, life insurance, or annuities

through the **use of a true or fictitious name which is deceptive or misleading** with regard to the status, character, or proprietary or representative capacity of the entity or person, or to the true purpose of the advertisement.

Further, advertisements shall not employ **words, letters, initials, symbols, or other devices which are so similar to those used by governmental agencies**, a nonprofit or charitable institution, senior organization, or other insurer that they could have the capacity or tendency to mislead the public. Examples of misleading materials, include, but are not limited to, those which imply any of the following:

- The advertised **coverages** are somehow provided by or are endorsed by any governmental agencies, nonprofit or charitable institution or senior organizations.
- The advertiser is the same as, is connected with, or is **endorsed by governmental agencies**, nonprofit or charitable institutions or senior organizations.
- No advertisement may **use the name of a state or political entity** in a policy name or description.
- No advertisement may use any name, service mark, slogan, symbol, or any device in any manner that implies that the insurer, or the policy or certificate advertised, or that any agency who may call upon the consumer in response to the advertisement, is **connected with a governmental agency**, such as the Social Security Administration.

It is also important that any advertising you employ does not imply that the reader may **lose a right, or privilege, or benefits** under federal, state, or local law if he or she fails to respond to the advertisement.

Further, an insurer, agent, broker, or other entity may not use an **address so as to mislead or deceive as to the true identity, location, or licensing status** of the insurer, agent, broker, or other entity.

Likewise, no insurer may use, in the trade name of its insurance policy or certificate, any terminology or words so similar to the name of a governmental agency or governmental program as to have the capacity or the tendency to confuse, deceive, or mislead a prospective purchaser.

No insurer, agent, broker, or other entity may solicit a particular class by use of advertisements which state or imply that the occupational or other status as **members of the class** entitles them to reduced rates on a group or other basis when, in fact, the policy or certificate being advertised is sold on an individual basis at regular rates.

Also remember, all advertisements used by agents, producers, brokers, solicitors, or other persons for a policy of an insurer shall have **written approval of the insurer before they may be used**.

Who is exempt from these rules? Any person or entity that is not required to be licensed and non-resident agents representing an insurer that is a direct response provider.

Advertising Defined (CIC 787b)

For the purposes of this section, an advertisement includes envelopes, stationery, business cards, or other materials designed to describe and encourage the purchase of a policy or certificate of disability insurance, life insurance, or an annuity.

Legally speaking, all client contact is considered advertising. So, be careful in any memos, e-mails or discussions you have with a client. Be sure you are not violating the spirit of any rules by inferring something about product, company or yourself that could mislead or confuse a client as to your ***real intentions***.

Required Information License Number

As a review, every licensee shall prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements distributed exclusively in this state for insurance products its ***license number*** in type the same size as any indicated telephone number, address, or fax number. If the licensee maintains more than one organization license, one of the organization license numbers is sufficient for compliance with this section.

Use of The Word "Insurance"

Effective January 1, 2005, every licensee shall prominently affix, type, or cause to be printed on business cards, written price quotations for insurance products, and print advertisements, distributed in this state for insurance products, the word "***Insurance***" in type size no smaller than the largest indicated telephone number. A penalty can be levied on ***each piece*** of printed material that fails to conform to this requirement.

The only exception here is if the failure to comply was beyond the control of the agent. In addition, this requirement does not apply to general advertisements of motor clubs that merely list insurance products as one of several services offered by the motor club, and do not provide any details of the insurance products.

Internet Sales

A person who is licensed in this state as an insurance agent or broker, advertises insurance on the Internet, and transacts insurance in this state, shall identify all of the following information on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if the presence is maintained on his or her behalf:

- His or her name as it appears on his or her insurance license, and any fictitious name approved by the commissioner.
- The state of his or her domicile and principal place of business.
- His or her license number.

A person shall be deemed to be transacting insurance in this state when the person advertises on the Internet, regardless of whether the insurance agent or broker maintains his or her Internet presence or if it is maintained on his or her behalf, and does any of the following:

- Provides an insurance premium quote to a California resident.
- Accepts an application for coverage from a California resident.
- Communicates with a California resident regarding one or more terms of an agreement to provide insurance or an insurance policy.

Seminars, Classes Meetings

In addition to any other prohibition on untrue, deceptive, or misleading advertisements, no advertisement for an event where insurance products will be offered for sale may use the terms "seminar," "class," "informational meeting," or substantially equivalent terms to characterize the purpose of the public gathering or event unless it adds the words "**and insurance sales presentation**" immediately following those terms in the same type size and font as those terms. Of course, advertising must also comply with requirements to display your license number.

Direct Mailers (CIC 787)

*Any advertisement or other device designed to produce leads based on a response from a potential insured which is directed towards persons age 65 or older shall prominently disclose that an **agent may contact the applicant** if that is the fact. In addition, an agent who makes contact with a person as a result of acquiring that person's name from a lead generating device shall disclose that fact in the initial contact with the person. So, if your product or way of operating requires an onsite visit or return phone call to a senior, you need to disclose that you will be contacting them.*

Fines and Penalties

Agents

Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation. Upon a second violation, an agent will be liable for an administrative penalty of no less than five thousand dollars (\$5,000) and no more than fifty thousand dollars (\$50,000) for each violation. In addition, if the commissioner brings an action against a licensee for the violations above and determines that he may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of a hearing.

Insurers

Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars (\$10,000) for the first violation. Second violations can bring a \$30,000 to \$300,000 fine and a rescission of the annuity or policy in violation.

SALES PRACTICES

State codes of insurance and thousands of legal actions against insurance producers focus on one thing . . . agent conduct. A few years ago, no one knew what **market conduct** meant. Today there are class action suits and negligence claims filed against insurers and agents alike

amounting to millions of dollars for a variety of sales and legal conduct violations. Of course, agent conflict is nothing new. Our research found cases dating back to the early 1800's. What is different between cases of today and the ones that occurred years ago is the trend toward fiduciary responsibility. In essence, the courts are viewing agents as **more than mere salesmen**. Recent cases, for example, lean toward the precedent that agents, as insurance professionals, **should have known** something was wrong compared to years ago where agent liability was generally limited to issues of **outright negligence**. There **is** a world of difference between the two that is best explained by the **legal precedent theory**. In a nutshell, because our legal system makes legal decisions based on precedents, it is destined to constantly expand. Each decision in the chain sets the stage for the next step of expansion. The result can be demonstrated court cases. In Southwest v Binsfield (1995), for example, the agent **should have known** that a specific coverage option was important to the business he insured. In Brill v Guardian Life (1995) the agent **breached his fiduciary duty** by not using an **optional** conditional receipt. Clearly, these cases represent an expansion of agent liability . . . from decades-old "contract" issues to fiduciary duties. Dozens of cases may have proceeded these cases: in each, the level of agent duty was notched higher and higher as attorneys convinced attorneys that agents should be held more accountable.

Agent accountability today may also come with a high price tag. Consider the following court cases where the actual dollar losses incurred by client victims was extremely low compared to the **high punitive damages** levied against agents and their insurers:

| | | |
|-------------------------------|-----------------------|-------------------------------|
| <i>State Farm v Grimes</i> | \$1,900 Actual losses | \$1.25 Million Punitive Award |
| <i>Independent v Peavy</i> | \$412 Actual losses | \$250,000 Punitive damages |
| <i>National Life v Miller</i> | \$258 Actual losses | \$350,000 Punitive damages |

As you read these amounts you may be thinking that the damages were high because insurance companies have **deep pockets**. They can afford to pay these sums of money, which is why juries awarded them. However, you must also keep in mind that virtually every agency agreement in existence has some kind of **indemnification clause** or wording that entitles the insurer to demand reimbursement from you, the agent, for malpractice, negligence or action leading to a jury award. In other words, if you have a contributing exposure to a problem that caused the insurer to pay-out big bucks, you probably have the same exposure when the **insurer** comes after you personally!

Reasonable Expectation & Detrimental Reliance

The majority of selling infractions by agents center around two legal concepts: reasonable expectation and detrimental reliance. Here is a brief summary of each:

Reasonable expectation

No matter how clear the language, **all policies** contain areas of **ambiguity**. When conflicts arise, the courts generally turn to **theories of reasonable expectation**. In a nutshell, if a policy could imply to a reasonable or average policy holder that coverage is in force or benefits exist, yet that exact language does not exist in the policy, then coverage / benefit DOES extend to the policyholder. In other words, the courts generally favor the insured.

Many times it is the agent's misrepresentation of policy terms that sways the client into believing he is covered or that an anticipated outcome will accrue, only to find out he is not or it doesn't.

Illustrations of annuity contracts with seemingly realistic rates of return and projected values is a clear example of how agents build a client's expectations. In cases where coverage or results were misrepresented, courts may interpret that the expectations of the client were at a level that a reasonable person would expect coverage or the intended results represented.

Detrimental Reliance

Where the insured reasonably believes he is covered or receiving a certain benefit by virtue of representations by an insurance agent or broker, the failure of the broker to produce the coverage/benefits or else warn the client at once that coverage/benefits could not be obtained constitutes a failure to exercise the requisite skill or diligence required of a broker. One of the key elements in a **detrimental reliance claim** is whether or not the reliance placed on the agent caused the insured to miss the opportunity to obtain alternative coverage or keep good coverage/benefits he already had.

As you will learn below, detrimental reliance is an important concept you must keep in mind when exchanging or replacing a client's coverage/benefits with another contract. A decision by that client to change, made on information you provided, should reasonably benefit the client in some, if not multiple ways . . . and the fact that you need a commission is not one of them!

Tax Consequences

Annuities are sold for their tax advantages. The laws are complicated and could have far-reaching effect on a client's overall yield. Agents have been known to underestimate tax consequence by forgetting to advise clients a tax exists or overestimate them in promoting the unnecessary replacement of a contract simply because the exchange will be tax free.

New legislation (**CIC 789.9, SB 620**) is clear when it comes to seniors: If a life agent offers to sell to an elder (age 65 or older) 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.

Medi-Cal and Annuities

For years, agents have seized on the fears of client's regarding Medi-Cal eligibility. Clients have been sold considerable product that purportedly exempts income or assets from the eligibility rules so as to believe they will qualify for Medi-Cal when the time comes. Many of these exemption holes have been plugged and there are penalties for people and their agents who attempt to abuse the system.

New legislation makes this very clear: A life agent who offers for sale or sells a financial product to an elder 65 years or older 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 (Section 789.9 of the CIC).

In addition, the following disclosure is required. The statement 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 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:

"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 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 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 Exemptions

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: _____ "

More Medi-Cal Restrictions

An annuity shall not be sold to a senior (age 60 years and older) in any of the following circumstances:

The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and either of the following is true:

- The purchaser's assets are **equal to or less than the community spouse** resource allowance established annually by the State Department of Health Services pursuant to the Medi-Cal Act.
- The senior would **otherwise qualify** for Medi-Cal.
- The senior's purpose in purchasing the annuity is to affect Medi-Cal eligibility and, **after the purchase of the annuity**, the senior or the senior's spouse would not qualify for Medi-Cal.

If an annuity is issued but violates any of these provisions, the insurer must rescind the contract and refund to the purchaser all premiums, fees, any interest earned under the terms of the contract, and costs paid for the annuity.

In-Home Solicitations (CIC 789.10, SB620)

In-home solicitations have been the source of senior abuse for years. Now there is specific legislative **criteria** that addresses this area of annuity sales.

Any person who meets with a senior (anyone age 65 or older) in the senior's home is required to deliver a **notice in writing** to the senior no less than **24 hours prior** to that individual's initial meeting in the senior's home.

If the senior has an existing insurance relationship with an agent and requests a meeting with the agent in the senior's home the same day, a notice shall be delivered to the senior prior to the meeting. The notice shall be in substantially the following form, with the appropriate information inserted, in **14-point type**:

In-Home Solicitation Form

(1) During this visit or a follow-up visit, you will be given a sales presentation on the following (indicate all that apply):

- () Life insurance, including annuities*
- () Other insurance products (specify): _____.*

(2) You have the right to have other persons present at the meeting, including family members, financial advisors or attorneys.

(3) You have the right to end the meeting at any time.

(4) You have the right to contact the Department of Insurance for information, or to file a complaint. (The notice shall include the consumer assistance telephone numbers at the department)

(5) The following individuals will be coming to your home: (list all attendees, and insurance license information, if applicable)"

Upon contacting the senior in the senior's home, the person shall, before making any statement other than a greeting, or asking the senior any other questions, **state that the purpose of the contact is to talk about insurance, i.e. you cannot misrepresent the true content of the meeting**, or to gather information for a followup visit to sell insurance, if that is the case, and state all of the following information:

- (1) The name and titles of all persons arriving at the senior's home.
- (2) The name of the insurer represented by the person, if known.

Each person attending a meeting with a senior shall **provide the senior with a business card or other written identification** stating the person's name, business address, telephone number, and any insurance license number.

The persons attending a meeting with a senior shall end all discussions and **leave the home of the senior immediately after being asked** to leave by the senior.

A person may not solicit a sale or order for the sale of an annuity or life insurance policy at the residence of a senior, in person or by telephone, by using any plan, scheme, or ruse that misrepresents the true status or mission of the contact.

Sharing Commissions (CIC 1724)

An agent, broker, or solicitor who is not 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 this section, "commission or other compensation" means pecuniary (consisting of money) or nonpecuniary compensation of any kind relating to the sale or renewal of an insurance policy or certificate or an annuity, including, but not limited to, a bonus, gift, prize, award, or finder's fee.

Replacement (CIC 10509.8)

While the replacement of one annuity with another is not a bad thing, the introduction of new restrictions make it clear the Department of Insurance wants focus on abuses. Agents who are particularly aggressive in this area should exercise extreme caution in the presentation and implementation of a replacement contract.

Unnecessary Replacement

A pattern of frequent replacements, especially those where the client did not materially benefit, is not only against insurance codes, it can be used to establish a detrimental reliance civil claim, i.e., you could be sued by your client. One of the key elements in a **detrimental reliance claim** is whether or not the reliance placed on the agent caused the insured to miss the opportunity to obtain alternative coverage or keep one that would have been just as good or better.

As a responsible agent, you should advise clients to explore the reasons they might consider a keeping what they have? Are they simply unhappy with their return? Would they have also lost money in a different contract? Would their existing insurer add a rider to enhance their death benefit to keep them from leaving? Is the contract meeting their original goal of legacy planning?

A correct analysis of any annuity replacement is a matter of common sense. What is your client leaving behind? What is he gaining in the move? Most experts believe there should be **multiple reasons and benefits** for justifying the **replacement** of a contract because of the associated costs in moving. For some, the first red flag is the current surrender. If it is more than 3 percent, a replacement plan would have to offer a lot to make up the difference. It would also be wise to write down why the current policy does not meet a client's needs, e.g., fees are higher and death benefit is lower than a replacement contract. Assessments of the actual surrender value invested (not a comparison of the original contracts investment) should

demonstrate that at various hypothetical returns, the move is reasonable. And, an evaluation of new surrender charges and a client's need to access his funds is a must.

Knowing this, let's understand the new law and look at some examples:

Replacement for Age 65 And Older

Under new code sections, you are in violation of California law if you recommend the replacement of an existing contract by use of a materially ***inaccurate presentation or comparison*** of an existing contract's premiums and benefits or dividends and values or annuity to a person **age 65 or older**.

For purposes of this section, "***unnecessary replacement***" means 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.

Substantial Financial Benefit

While ***substantial financial benefit*** is not defined in the code, a reasonable person would conclude that a contract owner should anticipate that the risk of exchanging or replacing one contract for another should amount to benefits that are ***more*** than an even swap; especially where surrender charges are required.

Example: Phil agrees to replace a \$100,000 deferred annuity earning 5% with a new contract offering a first year bonus of 7%. Surrender charges in the swap will amount to \$3,000. Over the life of the contract Phil calculates the replacement, after charges and taxes, made him a total of \$100. Is this a substantial financial benefit? Probably not, considering the amount of principal, risk and his time. How about 1,000 profit? Probably so. A move that nets \$1,000 against \$100,000 seems reasonable. Of course, the courts typically decide, on a case by case basis, what is reasonable. It is probably best to have multiple reasons for making a replacement.

Example: Irene has \$50,000 invested in a variable annuity. Her death benefit is equal to the original value or surrender value at time of death and all surrender charges have worn off. Her agent finds a new contract with a slightly better return, reduced charges, a short surrender period and an enhanced death benefit that increases the death benefit at surrender by 40% with no underwriting required. A substantial financial benefit? As long as Irene does not appear to need to access to her funds before the new surrender charges lift and the added death benefit is something she needs anyway, it seems reasonable that this replacement is warranted since Irene will substantially upgrade her death benefit. Before you recommend the move, however, wouldn't it be prudent to evaluate Irene's true life insurance needs first? Perhaps the added life coverage is available somewhere else or not needed at all.

Agent Knowledge

If there is a ***pattern*** that develops, where policyowners purchase replacement policies from the same agent yet owners indicate on applications that a replacement is not involved, it shall be considered that the agent has knowledge that replacement was intended. The point here is that some agents know full well the only benefit from a replacement is the commission. Attempting

to disguise the transaction is illegal and could cost you your license or a major lawsuit. This is exactly what happened in a recent case that received national attention. Agents knew they had to comply with state disclosure forms, but advised clients to leave out certain information or simply sign a blank form. The agents and company have paid dearly for this mistake.

Bait and Switch

Less than ethical agents use the illusion of providing a benefit to soften a client's perspective and then sell them something else. This is the classic definition of bait and switch. Many times the procedure is to **qualify** potential **victims** through a process of a deceptive interview or application . . . referred to as a **pretext interview** . . . with the sole purpose to gather confidential information. Often, clients are coerced into providing information under the guise of some potential benefit and once the information is retrieved, a product sales pitch is tailored.

Trust Mills

An example of this in the annuity area is the creation of what attorney's refer to as a **trust mill**. It's purpose was to provide unsuspecting clients the benefit of an inexpensive trust when the real purpose was to expose client assets to uncover and sell potential annuity prospects. On July 18, 1996 the California Attorney General and State Bar filed a joint lawsuit against the Alliance for Mature Americans, a non-law firm trust mill, in the Los Angeles County Superior Court. The lawsuit sought an injunction, more than \$200 million in restitution, and more than \$3 million in civil penalties. The lawsuit alleged that the Alliance for Mature Americans used "scare tactics" and unlawful and deceptive business practices to sell living trusts to senior citizens, some of whom suffered from Alzheimer's and Parkinson's diseases, in order to obtain confidential information to sell these persons annuities. The lawsuit also alleged that the Alliance for Mature Americans engaged in the unauthorized practice of law by training non-attorney salespeople to promote themselves as estate planning experts. In April, 1997 the Alliance for Mature Americans agreed to a settlement of the lawsuit whereby it would make restitution of \$1 million, pay a civil penalty of \$100,000, and discontinue its sales of estate planning services and living trusts.

As a result of this kind of deceptive practice, the Insurance Commissioner released a special bulletin in 2001 explaining agent and insurer responsibilities relating to any marketing scheme involving bait and switch tactics. A copy of this bulletin is provided (Attachment II) at the back of this course and is suggested reading by all agents.

Specific insurance codes have also been established to address these illegal activities:

No insurance institution, agent or insurance support-organization shall use or authorize the use of pretext interviews to obtain information in connection with an insurance transaction.

A **pretext interview is defined** as an interview whereby a person, in an attempt to obtain information about another person, perform one or more of the following acts:

- Pretends to represent a person he is not
- Pretends to represent a person he is not representing
- Misrepresents the true purpose of the interview
- Refuses to identify himself upon request

Long Term Care Sales

Sales of long term care coverage, some attached as riders to annuities, are another area of bait and switch abuse. Their purpose is to capture the client's fear of a long term illness in order to promote the sale of the annuity. This is not to say that these contracts do not provide long term care benefits . . . it simply isn't their sole purpose.

For example, for years now, the insurance industry has designed annuity contracts that appeal to the liquidity needs of seniors and other market groups. Most new generation annuity policies, for example, offer **free withdrawals** that allow the owner to withdraw from the account value every year in case of a medical emergency or long term care illness. However, sometimes agents sometimes forget to mention that only 10 to 15 percent can be withdrawn without incurring penalties.

Additional drawbacks to both long term care riders and annuity coverage should be noted, but often are missed, such as: Benefits paid may be less than the standard long term care policy, particularly in areas such as home health care and assisted living. Similarly, the duration of payments will most certainly be limited. And, without inflation protection, the proceeds may do little to cover actual LTC costs. "Pot of money" approaches will most likely be exhausted in a matter of years or sooner and few, if any, can be expected to provide lifetime benefits.

Other Unlawful Practices (BPC 6125)

It is important that agents do not represent themselves as having skills they do not possess in order to make a sale. The trust mill was just one example of this. Others include the practice of drafting, delivering and interpreting legal documents if you are unqualified to do so. An agent who decides to offer legal advice could be determined to practicing law without a license . . . a clear violation of the California Business and Professions . . . *No person shall practice law in California unless the person is an active member of the State Bar.*

Therefore, areas such as estate planning, eldercare planning Medi-Cal planning and tax planning should be left to the professionals who are trained to advise in these fields.

Suspension (CIC 1668.1, SB 618)

The State of California is serious about agents using their position to influence or misrepresent clients . . . especially senior citizens. That is the focus of SB 620 and SB 618. As such, new legislation has given the Commissioner the "teeth" to enforce illegal agent activities. One such method is license suspension or revocation.

Existing law prohibits a person from soliciting, negotiating, or effecting contracts of insurance, or acting in the capacity of various types of insurance agents, unless the person holds a valid license from the Insurance Commissioner authorizing the person to act in that capacity. Existing law authorizes the commissioner to deny an application for a license for various reasons.

The new law goes much further by authorizing the commissioner to suspend or revoke any permanent license issued if:

*A 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.*

Suspension, revocation and/or monetary penalties may also be assessed against any licensed agent who:

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 induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision a **beneficiary** under the terms of any intervivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy, OR 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 intervivos or testamentary trust, OR . . .

Use a **power of attorney** granted by client has to purchase an insurance product on behalf of the client for which the licensee has receives a commission, OR induces the client to provide the **benefits for 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. The **exception** to these rules is the case where transactions by the licensee are on behalf of a person related to the licensee by birth, marriage, or adoption; or a person who is registered as a domestic partner of the licensee.

Penalties (CIC 782, 789.3, 1738.5, 10509.9)—See Attachment III

The seriousness of the new legislation is also underscored in the penalties assessed for violations:

Misrepresentation of Policy Terms or Benefits (Section 780, 781, 782, 789.3 CIC)

Misrepresentation of policy terms, benefits, privileges, dividends; or to induce someone to buy one policy then sell another; or to mislead someone to forfeit his policy based on a false comparison is a crime and punishable by a fine not exceeding \$25,000 or 3 times the amount lost by the victim and / or by imprisonment not exceeding one year. The commissioner may also require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

Duplicate, Unnecessary Coverage / Deceptive Advertising (Section 1738.5, 10509.9 CIC)

Seniors who are abused via inaccurate, duplicated or unnecessary coverage. Or, who are deceived by an agent representing himself to be someone he is not will results in still penalties, including an administrative penalty of no less than five thousand dollars (\$5,000) for the first violation; \$5,000 to \$50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violations for the same offense can result in another \$10,000 fine for the agent and form \$30,000 to \$300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

Informed Decision / Reasonable Replacements

Annuity buyers are entitled to information to make an informed decision and the reasonable expectation that the consequences of a replacement of their existing policy is made. Agents not providing this are subject to an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation; \$5,000 to \$50,000 for a second violation. If the Commissioner at anytime believes the agent can be reasonably expected to cause harm to seniors, his license may be suspended. Further violation can result in another \$10,000 fine for the agent and from \$30,000 to \$300,000 for the insurer. Further, based on the outcome of a hearing, the agent's license could be suspended or revoked.

Failure to Refund A Contract Refund To A Senior

Seniors (age 60 and older) are now entitled to a 30-day free look and a total refund of their premiums. Insurers that fail to make these refunds in a timely manner will pay the applicant interest from the date the insurer or entity received the returned policy or certificate.

Day in Court

Any allegations of misconduct perpetrated against a person age 65 or over shall result in a hearing to be held within 90 days after receipt by the department of the notice. . . Based on the outcome of a hearing, the agent's license could be suspended or revoked.

ANNUITY SUITABILITY

In the world of insurance annuities, client's must decide **when** to invest, **what** to invest and **how much**. As an agent, it is your job to analyze needs and be an advocate or problem solver to make sure the requested benefits are delivered.

A client views annuity contracts in terms of obtaining **future benefits**, i.e., in most cases, your customers can only hope that the contract they purchase is appropriate. That is why agents are vital players in solving client needs. The greater agent due care exercised, the more valuable the service.

There are variety of techniques that are accepted and used to determine customer needs or suitability. Some are more traditional than others. Most are seen as solutions to **identify** a certain customer segment. They give logical, rational explanations about where the customer fits in but do not explain how the customer **feels and cares**. Contract applications are an example of information an agent might use to identify who he is about to invest.

Suitability Duties

At this point, you may be asking . . . what's the bid deal? People need annuities I provide it! Why does everything have to involve the law? Well, an agent has a legal duty to use **reasonable skill** in asking certain questions during the application process to determine types of coverage needed (Smith v Dodgeville Mutual Insurance – 1997). Further, failing to determine the nature and extent of the coverage/benefits requested as in Butcher v Truck Insurance Exchange - 2000, may subject you to a lawsuit.

For a majority of suitability lawsuits, the basis of liability is relationship and purpose. Legally a **personal relationship is created** when a prospective insured consults an insurance agent, provides that agent with specific information about his unique circumstances and relies on the agent to obtain appropriate coverage tailored to these circumstances. Courts have recognized that the relationship between a prospective insured and an insurance agent (like the relationship of attorney and client) is that of principal and agent, for the purpose of negotiating a policy suitable to the client's needs (Nu-Air Manufacturing Co. V. Frank B. Hall & Co. - 1987). Further, an insurance agent owes the prospective insured a duty of unwavering loyalty similar to that owed by an attorney to a client. It is the special **fiduciary nature** of the relationship between a prospective insured and an insurer that lends the relationship a **personal character** similar in scope to the lawyer-client relationship. For this reason, alleged acts of negligence on the part of an insurance agent who has been consulted for the **express purpose** of meeting a client's unique needs create a **personal tort**.

In Forgione v. State Farm Insurance - 1995, allegations in a complaint made clear that the insureds **expected** the agents to respond to the couple's unique, personal insurance needs. A \$600,000 claim proved that what they were sold was not a suitable contract.

In another case (Anderson v. Knox - 1961) agent Leland Anderson **specialized** in a particular type of insurance product. However, the court discussed the issue that this type of product could be useful for a person whose income and financial condition is such that his income tax puts him in high brackets and who has the means to liquidate the steadily increasing debt out of other sources. What brought about the controversy in this case was that Knox was **not** that kind of man. Premiums for the plan were over \$7,000 per year. Knox had an annual salary of \$8,100 per year and investment income of \$1,600 per year!

Was Anderson guilty of a breach of duty in a failure to make disclosure of certain facts? Was this product suitable? What about the rather large commissions, not ordinarily possible with a client in this income category? The court said . . .

'The appellant was an experienced expert in the field; the insured a mere layman who was led to believe that the plan would meet certain expressed objectives. Certainly the relationship was a fiduciary one in which the plaintiffs were entitled to believe the agent's material statements.'

The court determined that Knox **did rely** upon Anderson's statements and that it would be unreasonable to argue that Knox should have found out for himself, because of some principle of caveat emptor, that the program was not at all what it was represented to be.

The court awarded Knox compensatory damages, exemplary and punitive damages and damages for 'grievous mental anguish and great distress of body and mind'.

Suitability – Age, Tax & Financial Status, Investment Objectives

Beyond being the most responsible agent you can be, you should **size-up your client, his age, tax status and investment objectives** and **anticipate his needs** when he can't. How can this be accomplished? **Age** is one consideration. For instance, shouldn't you know that a 50-year-old baby boomer client is a far more complex individual than his parents before him. His insurance needs are also more complex: higher life limits to cover college and entrepreneurial pursuits; medical coverages, long-term care and bigger retirement "pots" for a longer life span; higher primary and umbrella coverages as a buffer against the litigation explosion; etc. Does

his **financial status** (balance sheet) provide him liquidity elsewhere? Does his **tax status** warrant an annuity? If he is in the lower brackets, the tax advantages mean less. Perhaps he is suitability from the standpoint that annuities are safe. What about his **objectives**? Does he need liquidity when he retires in 5 years, 10 years? Some annuities might not be suitable here.

To really uncover as many of these client needs as possible, you must know more about your clients. Of course, a client profile is the best way to accomplish this. Customer profiles can provide a lot more information than you would glean from an application. You must also **ask** clients what about their needs. Three important questions might be:

- *Have I given you all the information you need to make a decision?*
- *Does this information or policy make sense?*
- *Is there something else I can answer for you to assure you that this is the right solution based on your needs and objectives?*

In addition, you should do research about their needs as a group so you can **better anticipate insurance needs**.

Every additional bit of information you learn about your client helps you get closer to knowing what makes him "tick" and how he ticks could be a best indicator of how you need to insure him. Are you uncovering his or her "core beliefs"? Is he or she following generational trends? Where do they see themselves five years from now? How will they get there? These are not questions you will find on insurance applications nor many client profiles. In some cases, your clients will not know the answers to these questions themselves -- you may need to interpret for them. But, by all means never do this without involving them in the process.

And, of course, once you have asked all the questions you must be sure that you implement or **meet their needs to the best of your ability**.

Annuity Suitability & Seniors

In 2003, the National Association of Insurance Commissioners (NAIC) adopted the new **Senior Protection Annuity Transactions Model Regulation** (SPATMR). The purpose of this action is to establish guidelines for insurers and producers for determining suitability standards for fixed and variable annuities sold to senior consumers. These guidelines are available for various states to adopt and or modify in creating new suitability legislation which many do not currently have.

Key elements of SPATMR include the following:

- The model regulation creates standards and procedures for producers to follow when making annuity recommendations to individual seniors (over age 65) who are considering the purchase or exchange of a fixed or variable annuity.
- The model requires agents to make a **reasonable effort** to obtain information on a senior's financial, tax and investment objectives.
- The model establishes that producers must have **reasonable grounds** for recommending an annuity on the basis of facts disclosed by the consumer.

- The model establishes procedures to supervise and enforce compliance by producers through review of selling documents, training and period audits.

Identifying Need

The message of the NAIC and any suitability effort is the importance of identifying the need to gather information **prior or before** making any recommendation. At a minimum, this information should include information on the **client's financial status**, such as:

Income: What is the annuity prospect's current income? What are his needs in the future? What other sources of income are present today? Tomorrow?

Liquid Assets: What is the prospect's ratio of cash to hard assets? Is it adequate? How will this change in the future? Will purchasing an annuity negatively effect his liquidity?

Long Term Care: Does the prospect have a plan for long term care in place? Does he understand the need to have one before investing elsewhere? What other sources could help care for a long term care illness?

Tax Status: What is the prospect's tax bracket? Considering this, is an annuity advantageous or not? How will the future change his tax status?

Investment Objectives: Where does the prospect see himself in 10 years? 20 years? Is he realistic? If so, does he need to emphasize growth or income to get there? Does he have time to meet his goals? Is the prospect financial sophisticated? Is he capable of monitoring an investment plan such as a variable annuity?

Life Insurance: Does the prospect have life insurance? Is it adequate?

Other Information: Has the prospect taken advantage of retirement plan options available to him at work? Why not? Does he understand how they benefit him? Does he have time to create a meaningful plan? What is the prospect's tolerance for risk? What is the prospect's tolerance for insurance products? Non-insurance products?

Need For Full Contract Disclosure

Matching contract terms to client needs is another important aspect of determining suitability. Full disclosure of terms, surrender charges, expenses and important issues such as cash surrender benefits or death benefits that fall short of minimum nonforfeiture amounts are the only way your client can make an informed decision to proceed. Most contracts should have critical omissions like this prominently displayed in the policy. If not, it is your responsibility to bring them up. How will you know? Obtain specimen policies for every product you plan to offer. Carry them with you to show disclosures and to understand that all features of the contract are in line with your customer needs and objectives.

Record Keeping

Annuity contracts, like variable annuities, can be quite complex. You will need to stress to your client that he keep accurate records of subaccount investment choices as well as their performance.

Required Disclosures (AB 2107)

The thrust of the new annuity legislation is disclosure and suitability. Only then can you recommend a reasonable solution; only then can a client make an informed decision to purchase or pass.

Assembly Bill 2107 (2001) significantly strengthened disclosure in the selling of annuities . . . especially to seniors. This legislation requires agents to make specific disclosures about the consequences of financial transactions related to Medi-Cal eligibility. Many points of this legislation have already been discussed and the full text of this bill is included as Attachment II at the end of this course. To summarize:

- A special Notice Regarding Standards for Medi-Cal Eligibility is now required to be signed by the annuity buyer for any financial product geared to Medi-Cal or its eligibility.
- Agent conduct and history will be investigated and deemed to be relevant in any action or breach of duty concerning the selling of Medicare supplement insurance, long term care insurance, etc.
- The definition of senior financial abuse is expanded as well as the need for people who work among the elderly to act more responsibly by recognizing their rights to feel secure from abuse.
- Agents need to apprise seniors that the sale of existing assets or annuities in order to buy new ones can have negative tax consequences and associated penalties.

Policy Cancellations and Refunds (CIC 10127.10, 10509.6)

Senior citizens who purchase annuities must now be given the right to cancel them within 30 days. This law applies to all contracts sold and delivered after 1/1/04. Return of the policy during the cancellation period has the effect of voiding the policy from the beginning and placing the parties in the same position as if no policy had been issued. That means that all premiums and policy fees shall be refunded by the insurer. If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall receive interest on the paid premium at the legal rate of interest

If a variable annuity is involved, the owner, is entitled to a full refund of his account value. And, during the 30-day **free look** cancellation period the premium **must only be invested in fixed-income investments**.

These new rules are underscored by the need for every policy to print, in 12-point bold, the following disclaimers:

YOU HAVE PURCHASED AN ANNUITY CONTRACT. 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 THIS POLICY. AFTER 30 DAYS, CANCELLATION MAY RESULT IN A SUBSTANTIAL PENALTY KNOWN AS A SURRENDER CHARGE.

For **variable annuity** contracts, the disclaimer is slightly modified as follows:

THE 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 OR 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 THE 30-DAYS MAY RESULT IN A SUBSTANTIAL PENALTY, KNOWN AS A SURRENDER CHARGE.

The **free look provisions (CIC 786)** apply to persons 60 years and older and do not apply to contracts sold through group plans.



PART X: Annuity Reserves

The basic premise of a policy reserve is to stock up capital to cover anticipated losses, i.e. insurance reserves are a cushion against losses. The size of the reserve is relative to the type of coverage and experience. Insurers are even required to use projections and estimates to reflect the many contingencies that can effect loss reserves. Health insurance companies, for example, estimate claims that might occur after the policy expires. And, life companies

generally use discount factors to reflect the time value of money and changing mortality concerning policies of particularly long duration.

Insurance companies are constantly modifying and balancing their loss reserves to meet minimum regulatory requirements and yet not exceed IRS guidelines for maximum deductibility. A high level of reserves also depresses profit which highly concerns shareholders.

Mortality rates and reserve requirements change over time requiring constant modification to reserve levels. That is why policy reserves are usually grouped by block of business . . . policies issued in the same year with similar face amounts, interest assumptions, age and risk level of insured. Uniformity makes it easier to group and calculate reserves. Over the years, the size of the policy reserves builds until the mortality cost for the particular block of business is covered. Then, the holding of reserves decreases until reaching zero when final claims are paid.

Every life insurance company annually submits the opinion of a qualified actuary as to whether the reserves and related actuarial items held in support of the policies are computed appropriately and adequately meet the obligations of the company in relation to its obligations.

COMPARING LIFE AND ANNUITY RESERVES

The mechanics of how life and annuity reserves are precisely calculated is not a concern in this course. However, it is important to raise the issue that reserve requirements are quite different between many life and annuity products. And, this can limit an insurer's ability to sell and can impact a consumer's decision to buy.

For many life and even fixed annuity contracts, the world of reserves is fairly predictable. In a given pool, a Certain number of clients die, a certain number annuitize. The problem surfaces with some of the new variable breed of contract where guaranteed minimum death and guaranteed minimum income (living benefits) benefits can create major reserving problems.

Suppose, for instance, a holder purchases a guaranteed minimum income benefit contract that promises a guaranteed minimum distribution after 10 years. During that time, a series of factors (lower interest rates, poor portfolio results, weak economy, etc) cause the underlying investments in the contract to be less than anticipated. However, the insurer has guaranteed an income, and, if the contract holder chooses to annuitize, the company could be forced to payout more than the value of the account thus causing a tremendous strain on reserves. One or two clients would not be a problem, but an entire block of under-performing accounts could be a real financial threat to the insurer.

RESERVES AND SALES

Ordinarily, the backroom operations of an insurer are not of concern to the general public. However, recent events involving poor stock and bond performance coupled with historically low interest rates have combined to create reserving issues with most companies.

The inability to prove to regulators that reserves will be there when need, based on poor investment results, can **limit** the amount of product an insurer can sell and the **options** consumers have **to buy** them.

Additionally, **annuity payouts** at annuitization are greatly effected by the current rate of interest. Clients anticipating a certain monthly income from their annuity could find a lower payment is offered in response to lower market rates.



PART XI: Consumers & Annuities **At Retirement**

Americans are waking up to the fact that they may outlive their retirement plans. In fact, the average person could well live 30 years or more after they retire. In addition, the structure of managing income after retirement is changing: The old model of living off an annuitized income from pension plans and Social Security is giving way to a model where retirees must manage pools of capital on their own with an increasingly complex range of tax, health care and other financial issues to resolve. Retirement planning under these circumstances requires more planning and a bigger commitment.

Unfortunately, there is a limit to the amount of money consumers can contribute annually to tax-deferred retirement accounts like 401(k)s and IRAs. And, the thought of investing outside their retirement plans with after-tax dollars or without tax deferral does not help to build a retirement nest-egg all too quickly.

That is where annuities can help. The promise of tax-deferral during accumulation and a guaranteed lifetime income during retirement is attractive to many investors. And, with most annuities, there is ***no contribution limit***.

RISK AND THE SENIOR CLIENT

The ability to make unlimited contributions is one reason annuities are especially appealing for late-start investors, people who waited until their 40s or 50s to start saving for retirement. Unlimited contributions give late-starters a chance to catch up with their early planning peers. And because you can contribute to an annuity without having a current earned income, stay-at-home parents or people who have already retired can buy and add money to annuities.

Annuities are relatively safe investments. While they are not covered by federal deposit insurance, the principal and interest an individual invests in a fixed annuity contract are protected by the rigid state and federal regulations that govern insurance companies' operations. Yet, these regulations do not protect an investor from all potential problems. If the insurance company that sold an annuity to an individual experiences severe business problems and becomes insolvent, other insurance companies doing business in the same state will be required to help meet that company's remaining obligations.

Also, while the dollars that an individual invests in and earns through an annuity are relatively safe, the annuitant is not protected from ***purchasing power risk***. The fixed income received from an annuity loses its value in times of inflation. For example, while a monthly income of \$1,000 may sound adequate to an individual in 1990, that amount may seem trivial in 2010 if inflation has greatly increased the cost of living.

Since many investors purchase annuities to provide for living expenses during their retirement, the possibility of decreased purchasing power is an important consideration. The offset to this is the ability to buy variable and indexed annuities where investor money has the potential to grow tax-deferred in the investment subaccounts chosen or along with a pre-determined index. As with many financial options, there are risks here, such as fluctuations in principal and possible loss in value.

Annuities are relatively **liquid investments** because they provide ways for individuals to surrender their contracts and withdraw their funds during the accumulation period. They are not completely liquid, however, because investors may not receive the full amount that they have paid in as premiums if they decide to withdraw from their annuities. The amount that an individual would lose depends on the surrender fees and penalties assessed by the insurance company. These charges are described in the annuity contract.

Interest earnings on annuities have attracted many current investors. Rates in the last few years have been competitive, generally paying somewhat more than typical CDs. Guarantee periods vary with different insurance companies. Some will pay an initial rate for one or two years, followed by subsequent annual guarantees. Others will peg their rates to formulas based on treasury bill or consumer price indexes.

Consumer attitudes about annuities are not simply shaped by rates and terms. To some extent people are influenced by who is selling them. In the mid-1980's, banks began a huge campaign to promote and market annuities. It worked! The WWI generation had lots of money in banks and trusted them. They have done a lot to educate consumers on the benefits and pitfalls of annuities.

The **downside** of the equation is the fact that consumers can be easily convinced to buy the wrong kind of annuity or **buy too many annuities** without consideration for needed liquidity at retirement. In addition there are many **scam operations** that often misrepresent the disadvantages of seniors' current investments and the advantages of the investments they are selling. They may even make seniors believe their bank accounts are less safe than the annuities or other investments they want seniors to buy.

In their solicitations, some of these sales **agents often pose as expert** financial or estate planners. They pass themselves off as a "trust advisor", "senior estate planner", or "paralegal", and schedule an initial appointment with seniors in their homes. Under the guise of helping set up or update a living trust, the sales agents find out about seniors' financial assets and investments. They often work in assisted living centers, churches and other places where seniors gather, hooking elderly victims through free seminars and other sales presentations.

Senior abuse in the selling of annuities is the reason for recent legislation and the reason you are now required to take this course. The hope is that education such as this will prevent additional legislation so that you can be productive and understanding in the valuable role annuities can play in a consumer's retirement planning.



PART XII: State Guarantee Funds

ROLE AND PURPOSE

The purpose of the state guaranty associations is to fully guaranty the reasonable expectations of the vast majority of individual policy and group insurance certificate holders. It is important to note that these associations DO NOT exist to underwrite any and all promises, no matter how large or reckless. In essence, state guaranty associations have limitations.

Guaranty associations are created by state law (**CIC 1063**) to protect policy owners, insureds, beneficiaries, annuitants, payees and assignees against losses, both in terms of paying claims and continuing coverage, which might otherwise occur due to an impairment or insolvency of an insurer. When an insurer becomes insolvent, it frequently exits the market with liabilities in excess of its assets. The ultimate questions to be answered is: who is going to bear the burden of this shortfall? To date, state legislators have used guaranty funds to shift most of the burden of the shortfall from the policy holders of the insolvent company back to insurers. Absent guaranty fund protection, the policy holders of the insolvent insurer would be forced to absorb the complete loss produced by the insolvent insurer. Guaranty funds provide policy holders and beneficiaries with an entity ready to absorb most of the losses left by the insolvent insurer.

Guaranty funds are able to provide protection to policy holders by assessing surviving insurers for amounts necessary to pay the claims of the insolvent insurer. Essentially, these funds shift the burden of the shortfall from policy holders to surviving insurers. Managers of the surviving insurers must then allocate the assessment. Groups that could be called upon to absorb the assessment include: equity holders, policy holders, employees, and taxpayers.

LIMITATIONS

In general, guaranty acts exclude from coverage policies issued by entities that are not regulated under the standards applicable to legal reserve carriers. Insurance exchanges, assessment companies, fraternal, HMOs and, in many cases, the Blues (Blue Cross and Blue Shield -- especially where they have not been converted to legal reserve carriers), are commonly excluded.

The guaranty laws also commonly exclude from coverage policies or portions of policies under which the risk is borne by the policy holder or which are not guaranteed by the insurer. Variable contracts annuity contracts are once such example.

Significant variation does exist in the treatment of unallocated funding obligations (UFOs), including GICs, which are commonly purchased as pension plan assets on professional, sophisticated advice by pension plan trustees.

Most guaranty associations limit their protection to policy holders who are residents of their own state. (It does not matter where the policy owner's beneficiaries live.) However, if the insolvent insurer's domiciliary state follows the NAIC model, coverage would be extended by the domiciliary state to residents of another state if that state also has a similar guaranty act and the impaired company was not licensed there and the policy holder is not eligible for coverage there. An example of such a situation would be a New York resident who owns a policy of the

Executive Life Insurance Company, which is domiciled (chartered) in California. Since New York has a life-health guaranty association but the company was not licensed to do business there, New York residents will be covered by the California Life Insurance Guaranty Association. However, residents of a jurisdiction such as the District of Columbia which does not have a life-health insurance guaranty association would have no guaranty association protection, even though Executive Life was licensed there.

Other states, like Alabama, still follow an older model act and guaranty benefits of impaired or insolvent insurers domiciled in their own state, no matter where the policy holders live, and they also cover their own residents who are policy holders of licensed companies domiciled in other states, unless coverage is provided by the state of domicile.

Dollar Limits

Typical payouts to policy holders who are victims of failed or financially strapped insurance companies might read as follows:

Life and Health Guaranty Funds

Maximum Death Benefit \$300,000

Maximum Cash Value Covered \$100,000

Maximum Annuities \$100,000

Maximum Health and Disability \$100,000

Maximum Aggregate Per Person \$300,000

Property/Casualty Guaranty Funds

Maximum Claim \$300,000 - \$500,000

Individuals who have several policies may have additional limits. For example, a person who owned a term life insurance for \$500,000, a whole life policy with cash values of \$150,000 and a single premium annuity with an accumulated value of \$200,000, will collect ONLY \$300,000 -- the maximum aggregate limit per person regardless of how many policies. The fact that these policies may be spread among three different insurers does not make any difference. There would still be a \$300,000 maximum in most states. The same is true for property/casualty claims.

Regardless of the number of policies or how they are distributed among different insurance companies, the maximum claim that can be paid by a state guaranty fund is fixed at between \$300,000 and \$500,000 per individual. In addition to the individual annuity contract coverage provided, state life and health insurance guaranty associations generally cover individuals under group annuity certificates.

Where an individual has been issued evidence of insurance by or on behalf of the insurer, i.e., a "certificate", that individual is covered as though he had purchased an individual insurance policy. Coverage generally will be provided by the guaranty association of the state of residence.



ATTACHMENTS:

I: LEGISLATIVE HISTORY

II: AGENT DISCLOSURES

III: PENALTIES

Penalties Defined (Section 782, 786, 789.3, 1738.5, 10509.910 et seq. of the CIC)

| California Insurance Code | Violation | Penalty |
|---|--|---|
| <p>Section 782 Establishes penalties for violation of section 780 and section 781</p> | <p>Section 780 - Prohibited Misrepresentation Section 781 - Twisting (see page 3 for actual language)</p> | <p>Punishable by fine not to exceed \$25,000, or if victim loss exceeds \$10,000, the fine not to exceed 3 times the loss suffered by the victim, by imprisonment not to exceed 1 year or by both a fine and imprisonment</p> <p>Restitution to victim pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected</p> |
| <p>Section 786 Provides for an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract</p> | <p>no violations or penalties cited in this section (see page 3 for actual language)</p> | |
| <p>Section 789.3 Administrative penalties; amounts; rescission of contracts</p> | <p>Section 789.3: (a) and (b) by broker, agent, or other person engaged in the transactions of insurance other than an insurer (see page 4 for actual language) (d) and (e) by insurer</p> | <p>789.3(a) minimum \$1,000 for the first violation</p> <p>789.3(b) minimum \$5,000 and no more than \$50,000 each subsequent violation</p> <p>789.3(c) Commissioner may suspend or revoke license</p> <p>789.3(d) \$10,000 for the first violation</p> <p>789.3(e) minimum \$30,000 and no more than \$300,000 each violation thereafter</p> <p>789.3(f) Commissioner may require rescission of contract</p> |

| | | |
|--|--|--|
| <p>Section 1668.1 Acts that constitute cause to suspend or revoke any permanent license issued pursuant to this chapter</p> | <p>no violations or penalties cited in this section (see page 5 for actual language)</p> | |
| <p>Section 1738.5 A proceeding held pursuant to section 1668, 1668.5, 1738, 1739, or 12921.8</p> | <p>no violations or penalties cited in this section (see page 5 for actual language)</p> | |
| <p>Section 10509.9 Administrative penalties:</p> | <p>Section 10509.9: (a) and (b) by any agent or other person or entity engaged in the business of insurance other than an insurer (see page 6 for actual language) (c) and (d) by insurer (see page 6 for actual language) (e) by person or entity after a hearing (see page 6 for actual language)</p> | <p>10509.9 (a) \$1,000 for the first violation 10509.9 (b) minimum \$5,000 and no more than \$50,000 each subsequent violation 10509.9 (c) \$10,000 for the first violation 10509.9 (d) minimum \$30,000 and no more than \$300,000 each violation thereafter 10509.9 (e) the Commissioner may suspend or revoke the license</p> |
| <p>Section 10509.916 Insurer responsibilities</p> | <p>violations and penalties to be determined (see page 7 for actual language)</p> | |

Current Law

This list includes the statutes stated in SB 618 and the penalty statute from AB 689 (Chapter 295, Statutes of 2011) Insurance: annuity transactions, Section 10509.914 of the California Insurance Code, which will take effect on January 1, 2012.

Section 780: An insurer or officer or agent thereof, or an insurance broker or solicitor shall not cause or permit to be issued, circulated or used, any statement that is known, or should have been known, to be a misrepresentation of the following:

- (a) The terms of a policy issued by the insurer or sought to be negotiated by the person making or permitting the misrepresentation.
- (b) The benefits or privileges promised thereunder.
- (c) The future dividends payable thereunder.

Section 781: (a) A person shall not make any statement that is known, or should have been known, to be a misrepresentation (1) to any other person for the purpose of inducing, or tending to induce, such other person either to take out a policy of insurance, or to refuse to accept a policy issued upon an application therefor and instead take out any policy in another insurer, or (2) to a policyholder in any insurer for the purpose of inducing or tending to induce him or her to lapse, forfeit or surrender his or her insurance therein.

(b) A person shall not make any representation or comparison of insurers or policies to an insured which is misleading, for the purpose of inducing or tending to induce him or her to lapse, forfeit, change or surrender his or her insurance, whether on a temporary or permanent plan.

Section 782: Any person who violates the provisions of Section 780 or 781 is punishable by a fine not exceeding twenty-five thousand dollars (\$25,000), or in a case in which the loss of the victim exceeds ten thousand dollars (\$10,000), by a fine not exceeding three times the amount of the loss suffered by the victim, by imprisonment in a county jail for a period not to exceed one year, or by both a fine and imprisonment. Restitution to the victim ordered pursuant to Section 1202.4 of the Penal Code shall be satisfied before any fine imposed by this section is collected.

Section 786: All disability insurance and life insurance policies and certificates offered for sale to individuals age 65 or older in California shall provide an examination period of 30 days after the receipt of the policy or certificate for purposes of review of the contract, at which time the applicant may return the contract. The return shall void the policy or certificate from the beginning, and the parties shall be in the same position as if no contract had been issued. All premiums paid and any policy or membership fee shall be fully refunded to the applicant by the insurer or entity in a timely manner.

a) For the purposes of this section a timely manner shall be no later than 30 days after the insurer or entity issuing the policy or certificate receives the returned policy or certificate.

b) If the insurer or entity issuing the policy or certificate fails to refund all of the premiums paid, in a timely manner, then the applicant shall 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 shall be paid from the date the insurer or entity received the returned policy or certificate.

(c) Each policy or certificate shall have a notice prominently printed in no less than 10-point uppercase type, on the cover page of the policy or certificate and the outline of coverage, stating that the applicant has the right to return the policy or certificate within 30 days after its receipt via regular mail, and to have the full premium refunded.

(d) In the event of any conflict between this section and Section 10127.10 with respect to life insurance, the provisions of Section 10127.10 shall prevail.

Section 789.3: (a) Any broker, agent, or other person or other entity engaged in the transactions of insurance, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation.

(b) Any broker, agent, other person, or other entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this article a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars (\$5,000) and no more than fifty thousand dollars (\$50,000) for each violation.

(c) If the commissioner brings an action against a licensee pursuant to subdivision (a) or (b) and determines that the licensee may reasonably be expected to cause significant harm to seniors, the commissioner may suspend his or her license pending the outcome of the hearing described in subdivision (c) of Section 789.

(d) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars (\$10,000) for the first violation.

(e) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars (\$30,000) and no more than three hundred thousand dollars (\$300,000) for each violation.

(f) The commissioner may require rescission of any contract found to have been marketed, offered, or issued in violation of this article.

Section 1668.1: (a) The licensee has 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 in subdivision (e).

(b) The licensee has induced a client, whether directly or indirectly, to make the licensee or any of the persons listed in subdivision (e) a beneficiary under the terms of any inter vivos or testamentary trust or the owner or beneficiary of a life insurance policy or an annuity policy.

(c) The licensee has 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 inter vivos or testamentary trust. However, 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.

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

(e) Subdivisions (a) and (b) shall also apply if the licensee induces the client to provide the benefits in those subdivisions to the following people:

(1) A person who is related to the licensee by birth, marriage, or adoption.

(2) A person who is a friend or business acquaintance of the licensee.

(3) A person who is registered as a domestic partner of the licensee.

(f) This section shall not apply to situations in which the client is:

(1) A person related to the licensee by birth, marriage, or adoption.

(2) A person who is registered as a domestic partner of the licensee.

Section 1738.5: A proceeding held pursuant to Section 1668, 1668.5, 1738, 1739, or 12921.8 that involves allegations of misconduct perpetrated against a person age 65 or over shall be held within 90 days after receipt by the department of the notice of defense, unless a continuance of the hearing is granted by the department or the administrative law judge. When the matter has been set for hearing, only the administrative law judge may grant a continuance of the hearing. The administrative law judge may, but need not, grant a continuance of the hearing, only upon finding the existence of one or more of the following:

(a) The death or incapacitating illness of a party, a representative or attorney of a party, a witness to an essential fact, or of the parent, child, or member of the household of any of these persons, when it is not feasible to substitute another representative, attorney, or witness because of the proximity of the hearing date.

(b) Lack of notice of hearing as provided in Section 11509 of the Government Code.

(c) A material change in the status of the case where a change in the parties or pleadings requires postponement, or an executed settlement or stipulated findings of fact obviate the need for hearing. A partial amendment of the pleadings shall not be good cause for continuance to the extent that the un-amended portion of the pleadings is ready to be heard.

(d) A stipulation for continuance signed by all parties, or their authorized representatives, that is communicated with the request for continuance to the administrative law judge no later than 25 business days before the hearing.

(e) The substitution of the representative or attorney of a party upon showing that the substitution is required.

(f) The unavailability of a party, representative, or attorney of a party, or witness to an essential fact, due to a conflicting and required appearance in a judicial matter if, when the hearing date was set, the person did not know and could neither anticipate nor at any time avoid the conflict,

and the conflict, with the request for continuance, is immediately communicated to the administrative law judge.

(g) The unavailability of a party, a representative or attorney of a party, or a material witness due to an unavoidable emergency.

(h) Failure by a party to comply with a timely discovery request if the continuance request is made by the party who requested the discovery.

Section 10509.9: (a) Any agent or other person or entity engaged in the business of **insurance**, other than an insurer, who violates this article is liable for an administrative penalty of no less than one thousand dollars (\$1,000) for the first violation.

(b) Any agent or other person or entity engaged in the business of insurance, other than an insurer, who engages in practices prohibited by this chapter a second or subsequent time or who commits a knowing violation of this article, is liable for an administrative penalty of no less than five thousand dollars (\$5,000) and no more than fifty thousand dollars (\$50,000) for each violation.

(c) Any insurer who violates this article is liable for an administrative penalty of ten thousand dollars (\$10,000) for the first violation.

(d) Any insurer who violates this article with a frequency as to indicate a general business practice or commits a knowing violation of this article, is liable for an administrative penalty of no less than thirty thousand dollars (\$30,000) and no more than three hundred thousand dollars (\$300,000) for each violation.

(e) After a hearing conducted in accordance with Chapter 4.5 (commencing with Section 11400) and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner may suspend or revoke the license of any person or entity that violates this article.

(f) Nothing in this section shall be deemed to affect any other authority provided by law to the commissioner.

Section 10509.916: (a) An insurer is responsible for compliance with this article. If a violation occurs, either because of the action or inaction of the insurer or its insurance producer, the commissioner may, in addition to any other available penalties, remedies, or administrative actions, order any or all of the following:

(1) An insurer to take reasonably appropriate corrective action for any consumer harmed by the insurer's, or by its insurance producer's, violation of this article.

(2) A managing general agent or an insurance producer to take reasonably appropriate corrective action for any consumer harmed by the insurance producer's violation of this article.

(3) Penalties and sanctions pursuant to Section 10509.9. For purposes of Section 10509.9, this article shall be deemed to be part of Article 8 (commencing with Section 10509), and the

commissioner may in a single enforcement action seek penalties for a first and a second or subsequent violation.

**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 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: _____

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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 6**

BILL NUMBER: AB 2107 CHAPTERED
BILL TEXT

CHAPTER 442
FILED WITH SECRETARY OF STATE SEPTEMBER 14, 2000
APPROVED BY GOVERNOR SEPTEMBER 13, 2000
PASSED THE ASSEMBLY AUGUST 29, 2000
PASSED THE SENATE AUGUST 28, 2000
AMENDED IN SENATE AUGUST 24, 2000
AMENDED IN SENATE AUGUST 18, 2000
AMENDED IN SENATE AUGUST 7, 2000
AMENDED IN ASSEMBLY MAY 31, 2000
AMENDED IN ASSEMBLY MAY 16, 2000
AMENDED IN ASSEMBLY APRIL 24, 2000
AMENDED IN ASSEMBLY APRIL 3, 2000

INTRODUCED BY Assembly Member Scott
(Coauthor: Assembly Member Jackson)

FEBRUARY 22, 2000

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,

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 7**

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 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 take 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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 8**

(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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 9**

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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 10**

(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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
Page 11**

(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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
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(SAMPLE FROM INSURER)

TITLE: _____

To: _____
Prospective California Client (*please print*)

From: _____
Agent (*please print*)

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

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 \$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.

**Life Agent Disclosure Requirements
for Sales to Elders - Assembly Bill 2107
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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: _____

Signature: _____

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.

Provider Legislative Reference

Annuities

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- 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-contract-form 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.

Year: 2002

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.

Year: 2000

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.

Provider Legislative Reference

Annuities

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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.

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