A Guide to Avoiding Common Annuity Owner Issues

Tips and Strategies to Help You Make the Most of Your Hard-Earned Assets
Annuities can be very powerful vehicles that can be used to address many individuals’ financial needs. However, some annuity owners find themselves making decisions that can undermine the effectiveness of their contracts, and therefore, this booklet is provided to help you:

1. Have a clearer understanding of the annuity products and features available to you.*

2. Learn strategies to potentially reduce the burden of unnecessary taxes.**

3. Leave your loved ones more of your valued estate.

4. Potentially increase your retirement income by properly handling your annuity.

5. Avoid simple issues that could potentially cost you or your beneficiaries.

**Note: This resource is designed to provide general information on the subjects covered. Pursuant to IRS Circular 230, it is not, however, intended to provide comprehensive tax or legal advice, and it reflects the tax and legal rules and regulations in effect at the time of its publication. Personalized Brokerage Services and Spectra Asset Conservation, LTD., does not provide legal or tax advice. You should consult a professional tax advisor or attorney.
TIP #1

Clearly define your needs before making your purchase.

In today’s complicated financial world, one rule remains very simple – it’s best to know what you’re looking for before you actually buy.

Annuities are long-term vehicles for retirement that generally offer tax deferral, a variety of income options, and a death benefit.

There are a number of different kinds of annuities available, and each has its own unique features, capabilities, and benefits. Before sitting down with a financial professional to discuss whether or not you should consider purchasing an annuity consider what the product would need to do in order to help meet your financial goals or objectives. For example, ask yourself:

- What do you want to achieve with these assets?
- What access do you need to this money?
- What prior experiences may have influenced your future financial strategy?
- What foreseeable life events may be factors in determining the kind of product you purchase?
After reviewing your options with a financial professional, ask yourself if the given product matches up with your:

- Short-term financial goals & objectives
- Long-term financial goals & objectives
- Risk tolerance level
- Current and/or anticipated tax status
- Wishes for leaving a legacy to loved ones

In the course of your conversation, you are bound to have a number of questions about the product(s) you’re considering. Don’t leave any stone unturned – ask your financial professional to address any questions you may have, so that you may be assured that you have a thorough understanding of the product you’re thinking of buying (or exchanging).
Finding the best way to accumulate wealth for retirement can be challenging. Many individuals look to annuity products with premium bonuses to help their retirement savings. What does this mean? A ‘premium bonus’ is simply additional interest automatically credited to your annuity’s value (per the conditions set by the issuing company).

For example, if you put $100,000 into an annuity with a 5% premium bonus, your annuity’s accumulation value would be credited with an additional $5,000. This bonus is credited by the issuing insurance company, and the crediting generally takes place in the first year. In some cases, any additional premiums you add to the annuity contract for a specified time period can also be credited with this bonus. (This all depends on the specific contract’s provisions, and your financial professional can help you review which terms and features are most appropriate for your needs.)

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<tr>
<th>Initial Premium Paid:</th>
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<tr>
<td>Premium Bonus:</td>
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<td>Bonus Amount Credited to Accumulation Value:</td>
<td>$5,000.00</td>
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(This hypothetical example is provided for illustrative purposes only.)

What’s important here is that you understand the company’s specific rules and guidelines as they relate to receiving maximum benefit of the premium bonus. For example, companies may require you to hold the annuity for a given length of time without ‘cashing out’ (also known as ‘surrendering’ your contract), or without taking even partial withdrawals or they may require you to take a specified payout option to receive the full premium bonus.
As you’d likely expect, the larger the bonus offered, the longer you may be required to hold the contract or take some form of income option. Bonus annuities may include higher surrender charges, longer surrender periods, lower caps, or other restrictions that are not included in similar annuities that don’t offer a premium bonus. In many cases, the trade-off of the bonus for the longer term of the product may still be well worth it.
TIP #3

Pay attention to the renewal rate offered by your annuity.

Many insurance companies offer first year interest rates that are higher than the ‘going rate’ of other vehicles. Following this first year rate, the rate thereafter (known as the renewal rate) may be considerably lower, and you may face several years of penalties or surrender charges if you cancel your contract or move your money to another annuity product**. Significant fees and charges may be incurred when transferring out of an annuity, including the possibility of paying front-end fees when purchasing a new annuity.

Just be cautious here. If you see a rate that appears to be exceptionally high, do your homework. There are many factors that determine whether a particular annuity is suitable or ‘right’ for you. There are many other important factors to explore. Also understand how an interest rate works with the annuity product. The rate may be earned each year only on the initial purchase amount, and not on the current accumulation value.

Before buying a new annuity, investigate the interest rates. If you already own an annuity, have it reviewed by a financial professional. In some circumstances, it may be a wise decision to consider another product that appropriately meets your current needs and objectives.

Many individuals never consider this idea of exchanging their existing annuities for new ones because they’ve heard they will have to pay taxes on the interest they’ve gained over the past several years. As long as you are following the rules set forth by the Internal Revenue Code (IRC), that’s not true, and tax-free exchange may be possible. A financial professional can assist you in reviewing important questions that can help you determine if this kind of exchange – known as a 1035 exchange – is truly in your best interest.
The 1035 exchange mentioned in Tip #3 refers to the section of the federal tax code that allows individuals the flexibility to exchange one non-qualified annuity for another without incurring any immediate tax liabilities or penalties. A 1035 exchange is most typically utilized when an annuity holder decides they want to exchange one annuity for another, but they do not want to activate unnecessary tax liabilities that would typically be encountered when surrendering an existing annuity contract. Under IRC Section 1035, when one non-qualified annuity contract is exchanged for another, the transfer is considered a nontaxable event if specific guidelines are met.

One such guideline is that you must keep the exchange ‘like-to-like.’ This means that you must be exchanging ‘like products’ and you must keep the owner (for example, an annuity contract for an annuity contract) the same on the old contract and the new contract. (There are a number of additional limitations and restrictions associated with a 1035 exchange, and it may be in your best interest to speak with a financial professional and/or Certified Public Accountant to ensure all guidelines are met prior to officially making the exchange.)

Some individuals assume that a tax-free 1035 exchange is accomplished simply by signing over a check with the proceeds from their first annuity company to the new annuity company. This is not the case. Requirements for tax-free exchanges state that non-qualified annuity funds must go directly from the current carrier to the new carrier. The same is true for what’s known as partial 1035 tax-free exchanges. This means that if you surrender your contract and ask that a check be sent directly to you (with the hopes of speeding up the transaction to the new company), a taxable event will occur, and you will be required to pay income taxes on the interest gained in the first annuity. If you are under age 59 1/2, you may also be required to pay an additional 10% federal tax. Different rules apply when moving funds from one qualified annuity, such as an IRA, to another.
It is not unusual for someone to name a trust as the owner of one’s non-qualified annuity. Though this may be a wise move for some individuals, it may greatly limit the options and flexibility for others. For example, if a trust owns a husband’s annuity and he passes away, his wife may not be able to directly assume ownership of that annuity at his death, continuing deferral of taxes and maintaining control of the product as though she were the original owner. Instead, she may be forced to pay taxes on the gains of the annuity – a choice she may not have wanted to make at that time. If all beneficiaries of the trust are not natural persons (living, breathing human beings), then the annuity owned by the trust may not qualify for income tax deferral.

Depending on your unique financial situation, it may also be wise to seek the counsel of an estate planning attorney or tax advisor. This type of specialist can assist you in creating a strategy to potentially reduce the estate taxes owed when you pass away. This is a frequently overlooked aspect of many families’ financial strategies. Sadly, they spend years, if not decades, accumulating estates, only to lose significant portions of those estates to state and federal taxes. It is not uncommon to see combined estate taxes in excess of 35%***, and in some cases, they can range even higher.

What does that mean? That means that after the estate pays a 35% combined estate tax on a $5 million estate, the beneficiaries of that estate could be left with a mere $3.25 million.**** This isn’t the kind of legacy most individuals work a lifetime to leave their loved ones, and with an appropriate strategy, you may be able to dramatically reduce the estate tax burden at your passing. ■


****This example does not take into account the federal estate tax exclusion amount, which is $5.12 million in 2012 and is scheduled to be $1 million in 2013.**
Many individuals assume that their beneficiaries will want to receive proceeds of their annuity settlement as a lump sum of money. That may not be the case in many situations. For instance, some beneficiaries may rather take the funds in the form of an annual payout over a number of years once they are shown how the income is distributed over time and how much income taxes may be reduced.

Some of today’s annuities - especially those with larger premium bonuses - require that the settlement (or death benefit as it’s often referred to by insurance companies) be received as an income payout. This may limit some of the beneficiaries’ options, but it may not inherently be a bad thing. In addition to potential tax advantages, forced income payout plans also provide a ‘legacy’ that is paid out over a period of time, which may fall closer in line with the wishes of some individuals leaving money behind for children or grandchildren. Like it or not, once a beneficiary receives a lump sum inheritance, that money can be spent very quickly, and some individuals would prefer to have the inheritance they leave last over a period of several years.
One of the more common and costly oversights made by annuity owners is the failure to update their beneficiary information, or to verify that their beneficiary designation is stated clearly and can be fulfilled by the insurance company. This may seem trivial, but in many cases, beneficiaries are set at the time a contract is initially signed, and they are never reviewed again. Changing circumstances such as marriage, divorce, birth of additional children, death of an existing beneficiary, etc., can all create potential changes to your current beneficiary designations.

Consider these possible situations if beneficiary designations are not updated¹:

1. A wife names her husband as her sole beneficiary on her annuity. He predeceases her, and since he is not available to receive the proceeds of her annuity at her death, it becomes part of her estate. This means it goes through probate, and her wishes for the proceeds may not be fulfilled.

2. A grandfather has three grandchildren, and he names them as equal beneficiaries of his annuity. One of his daughters has twins a few years later, and the beneficiary designations are never updated to include these two additional grandchildren. At his passing, the proceeds are dispersed as instructed to the first three grandchildren, and the twins never receive an equal portion.

3. A woman designates her husband as her primary beneficiary, and because they have no children, she elects no contingent beneficiaries. After a bitter divorce, the woman remaries but forgets to ever change her beneficiary designation. At her passing, her first husband receives the proceeds of her annuity because the forms were never updated.

These are all outcomes that could have been avoided by simply monitoring beneficiary designations. Financial professionals and attorneys often suggest that you have ‘back-ups’ in mind for both your primary and contingent beneficiaries and that you review them at least every few years.

¹The examples presented are for illustrative purposes only
Sometimes, individuals plan to leave the proceeds of their annuities to children or grandchildren. However, in many cases, state laws can tie up the proceeds of an annuity if a minor is the named beneficiary. In these cases, minors don’t have the legal capacity to execute a contract, and they can’t exercise contract-ownership rights, request annuitization, or make withdrawals.

There are possible solutions for this dilemma. For example, you may be able to:

— Set up a trust fund for the children or grandchildren naming the trust as the recipient of the contract’s proceeds*

— Provide instructions according to the insurance company’s procedure (if any) for restricted payment forms to a beneficiary without requiring an appointed guardian or a custodial arrangement under the Uniform Transfer to Minors Act.

*Note: Setting up a formal trust will generally come at a cost, but it may be a wise move depending on your situation. If you’re dealing with a sizable amount of money and you have very strong wishes to distribute those funds to a beneficiary that is currently a minor, it may be worth your time and money to set up a trust, and doing so may be accomplished by consulting an attorney.
In many older annuities, the primary method of accessing your money was known as ‘annuitization.’ In simple terms, this simply meant that after years of saving or accumulating in your annuity, you turned on the spigot and started an irrevocable stream of income from your annuity. Once you had turned that spigot on, it could not be turned off. This was particularly concerning in situations in which the owner of the annuity elected a ‘lifetime annuitization’ because in those cases, if there was anything remaining in the annuity after the individual’s death, the balance was kept by the insurance company that issued the contract.

Another drawback of annuitization was that you lost control of your money. Once you annuitized, you generally could not go back and increase or decrease the amount of your monthly, quarterly, or annual payment. This could pose a serious issue if you needed more income than your annuity was providing or if the annuitization payment was not keeping pace with rising inflation.

Increased scrutiny, regulation, and company innovation have led to products that don’t require this traditional “annuitization” to access your money. Understand your options here. Some newer annuities offer options called systematic withdrawals which allow you to set up a schedule of monthly, quarterly, or annual income distribution amounts that can be adjusted along the way. Should you pass away, the remainder (if any) of your annuity’s funds can go to your stated beneficiary rather than being lost to an insurance company or passing through the lengthy process of probate. (These systematic withdrawal options, often available in the form of contract riders, may come at an additional cost and may come with certain additional limitations and restrictions which you will want to fully understand as a contract holder.) The taxable portion of each payment from a non qualified annuity is determined differently for systematic withdrawal amounts than for annuitization payments. Annuitization payments generally receive more favorable tax treatment.
“Required Minimum Distributions” (RMDs) are the distributions, defined by the Internal Revenue Code, that you must start taking annually from qualified retirement plans and IRAs (other than a Roth IRA during the owner’s lifetime) generally by April 1st of the year following the year you turn age 70 ½. RMDs also apply to all beneficiaries of qualified retirement plans and IRAs, including Roth IRAs.

What’s at stake if you don’t take your RMD? The Internal Revenue Code imposes a 50% excise tax on the amount of the RMD not taken. This can obviously vary depending on the amount of RMD you were to take. For example, if you failed to take a $15,000 required distribution, you could be penalized $7,500 in taxes simply for failing to take the mandated amount.

A financial professional can assist you in calculating your RMDs each year to ensure that you avoid these unnecessary penalties and taxes. There is absolutely no reason to suffer these consequences, and a financial professional can help you to ensure that you meet the IRC’s annual RMD stipulations.

Please note that in the case of annuity contracts held in IRAs and qualified plans, the actuarial present value of additional benefits contained within the contract must be included in the RMD calculation each year. If you must take an RMD from an annuity contract, you will need to obtain this value from the insurance company each year. In many cases, the insurance company will provide this value automatically.

In Summary

As a reminder, this guide is not meant to provide tax or legal advice. It is simply meant to deepen your understanding of simple annuity tips and help you make more informed decisions as a consumer. For more information on the different types of annuity products available to you, contact Spectra Asset Conservation, LTD.
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Due to his outstanding professional accomplishments, Charles is recognized in the top 1% of financial advisors in the nation. He has been awarded the highest honor in Texas by being placed in the TRLT Grand Council and the Top of the Table for Million Dollar Round Table. Holding the honor of Top Producer under his marketing group, Charles bases his success on his “Client Comes First” attitude.

A member of the National & Texas Association of Insurance & Financial Advisors (NAIFA & TAIFA), Charles also serves as President and Director for NAIFA-Fort Worth and is a Child Advocates (CASA) of Tarrant County Board Member.

Charles teaches Sunday school at his church, enjoys playing golf, and working on his farm in Decatur. Charles and Vicki, his wife of nearly 40 years, have three children and three grandchildren.