ANNUITIES

Annuity Types

- Accumulation Annuities – Periodic Deposits accumulate with earnings over time, with (a) the right to apply the accumulation to an immediate annuity in the future, or (b) surrender for cash.
- Immediate Annuities- In exchange for a Single Deposit, the annuity immediately provides a stream of income for life, joint life, and/or period certain.

Accumulation Annuities

- Purchased by individuals or corporations to accumulate funds for future use. **Occasionally purchased by corporations as an informal funding vehicle for Deferred Compensation Plans, in lieu of COLI or Mutual Funds, as (a) an offset to Deferred Compensation Liabilities, and (b) cash flow for future benefits (but see limitations on withdrawals below).**

- Deposit(s) with insurance carrier grow with earnings (i.e., account value) (a) at a fixed or declared interest rate and called a fixed annuity , (b) variable investment selection analogous to Variable Life, and called a Variable or Separate Account Annuity, or (c) Equity Indexed Annuity- account value growth models some index, such as the S&P.

- Most annuities have a surrender charge or a "market value adjustment" (MVA), for surrender in the early years. Consequently similar to life insurance, accumulation annuities will have a cash surrender value that could be less than the account value for a number of years. An MVA could actually result in the surrender value being less than the amount paid in.

- Withdrawals or distributions may be made from the annuity at any time.

- For individuals, the account value growth is tax deferred until funds are withdrawn. Funds withdrawn are taxed on a LIFO (last in first out, or "earnings first") basis.

- ***For corporations (i.e., non natural persons,) the cash value growth is taxed each year*. Each year taxable income = (Cash surrender value + all distributions received) – (Total Deposits + all amounts previously taxed)**

Accumulation Annuity withdrawals (including a complete surrender) are subject to a 10% penalty tax. For individuals, the penalty tax will apply to withdrawals prior to age 59 ½ [subject to certain exceptions (death, disability, receiving substantially equal periodic payments)]. ***For corporations (i.e., non natural persons,) the 10% penalty tax always applies.***

- Death Benefits - If the annuitant/owner (usually the same) dies within the accumulation period, the annuity death benefit is typically the greater of the deposits made or the account value. Annuity Death Benefits, unlike life insurance death proceeds, are immediately subject to income tax (amount received over basis) UNLESS, within 60 days, account is used to purchase an immediate annuity.

Funding Deferred Compensation Plans by Corporations
Used occasionally as a funding vehicle, in lieu of COLI or Mutual Funds.

The main disadvantage of using an annuity, as compared to COLI, is the annual taxation of growth and the 10% penalty tax.

Another disadvantage is the "Aggregation Rule." Similar to BOLI, all annuity contracts purchased by the same policyholder, from the same insurer during any calendar year are aggregated and treated as one contract. This rule prevents accessing basis until the gain from all contracts has first been withdrawn.

- **<u>Corporate Accounting</u>**
  Corporate Accounting is similar to accounting for COLI:
  -Increase in Cash Surrender Value (CSV) booked as an asset
  -Excess of deposit(s) over CSV booked as an expense
  -No Deferred Tax Accounting
  -Increase in CSV is taxable to corporation

  Example: Initial Deposit of 100,000, first year CSV of 98,000

	DR	CR
Cash		100,000
Asset	98,000	
Expense	2,000	

Immediate Annuities (IA's)

- In exchange for a Single Deposit, the annuity immediately provides a stream of income for life, joint life with another party (typically spouse), and/or period certain.

- **IA's have no Accumulation or Cash Surrender Value and are not used to pre-fund a Deferred Compensation Plan.**

- Part of each annuity payment received is subject to ordinary income tax.
  - The part received free of income taxed is determined by calculation of an "Exclusion Ratio (ER)
  - ER = Investment in the Contract/Expected Return
  - Investment in the Contract is the Single Deposit
  - Expected Return is calculated based upon formulas promulgated by the IRS