The following article, which appeared in the November, 2006 issue of *The Journal of Financial Service Professionals*, won First Place in the Kenneth Black, Jr. Journal Author Award for 2006. It appears here by permission.

Annuities and Suitability: Reflections on the State of the Debate

by John L. Olsen, CLU, ChFC, AEP

ABSTRACT:

The current debate about annuities – if and when they are appropriate – is cluttered with assumptions and pre-conceptions. The polemic on both sides often obscures more than it reveals, and makes it difficult for objective advisors to judge when an annuity is or is not suitable for a client. This article examines the issues of suitability from a non-partisan position and offers some "bright line tests" as to when annuities may, or may not be, appropriate.

OVERVIEW

One of the most controversial subjects in the financial services industry these days is that of *annuities*. A great deal is being written and said about these contracts and much of it is highly favorable or highly unfavorable, often to the point of polemic. Sadly, this sort of polarized debate does little to increase understanding. Even worse, for the state of our understanding, is the fact that much of the discussion about the value, appropriateness, or suitability of annuities, even whn written from a balanced perspective, treats the subject as if it were homogenous – as if all annuities were alike, or at least so similar that one can properly make generalizations that apply to all of them.

That is simply not true; annuities are not homogenous. There are different types of annuities, and the various types are structured, and perform, *very* differently. Any assessment of the value of an annuity in a given set of facts and circumstances must specify the sort of annuity being considered. A generalization such as "an annuity is not appropriate for anyone over age 65" is simply nonsense – *not* because a valid case cannot made for the inappropriateness of *certain types* of annuities for such buyers, but because the various types are so different that the *reasons* that could reasonably be offered to support such an assessment could be valid for one type of annuity, yet totally irrelevant to another. For example, the annual costs of variable deferred annuities have no counterparts in traditional fixed deferred contracts. More to the point, deferred annuities and immediate annuities are so hugely different that a true statement about one will generally be untrue of the other.

In addition to this problem of *undifferentiation* (the failure to distinguish between the very different types of contracts when making generalizations about annuities), there is the troublesome fact that most critics of annuities, and many who favor them, frame their arguments from the perception of an annuity as an *investment*[1] vehicle. The trouble here is not that an annuity cannot be an investment, but, rather, that it's never *only* an investment. Any annuity is, to some extent, a *risk management tool*, and to the extent that it is being used as such, the charges for the risk management benefits it offers are *insurance costs*, not merely drags on investment performance. Focusing on one element of a subject, as if were the only one, is not sound analysis, and treating some costs as mere "overhead" (by dismissing, or ignoring entirely, the benefits purchased by those costs) is downright specious. Equally flawed is the focus of many proponents of deferred annuities upon the tax-deferral enjoyed by such contracts as though such treatment is always desirable and, all too often, without any consideration of the inescapable tax trade-off (the unavailability of Capital Gains treatment).

The debate over annuities would be greatly improved, and far more productive, if participants would recognize a few essential, often unconsidered, facts about these contracts. The author suggests the following for the reader's consideration (realizing that it is not a complete list):

ITEMS TO CONSIDER, WHEN DISCUSSING ANNUITIES

1. *Deferred* annuities and *immediate* annuities are very different instruments, designed to accomplish very different – indeed, mutually exclusive – objectives.

2. *Fixed* deferred annuities and *variable* deferred annuities have at least as many differences as similarities. Arguably, the defining element of each is absent in the other.

3. There is more variation, even within one specific type of annuity, than is usually acknowledged. For example, the criticism of a fixed immediate annuity as offering no inflation protection is true of only *some* contracts.

4. *Deferred* annuities are not purely *accumulation* instruments. Some types work better in that capacity than others, and all can be (and sometimes are) marketed that way, but the guarantee of a *certain* income is a central promise of every deferred annuity. (Immediate annuities, of course, are *not* accumulation tools; they're all about immediate *income*).

5. Annuities – arguably, *all* annuities – are both *investment* and *risk management* tools[2]. The guarantees they provide reduce the purchaser's risk. The cost of those guarantees may properly be considered as mere "overhead" (as drags on investment performance) only to the extent that the guarantees are judged to have no worth (that is, that they are neither needed nor wanted). This is not to say that one is obliged to value any such provision as worth the price charged. A particular buyer may, for example, consider the *guaranteed death benefit* in a

variable annuity as valuable, but overpriced. If so, the *excess* cost (the difference between the contractual charge and a charge the buyer considers “fair”) could logically be viewed as mere “overhead”.

6. Viewing the costs and benefits of an annuity entirely with conventional financial mathematics may produce an incomplete picture. Some of the benefits annuities offer have more to do with emotion than with financial ratios. For example, if the presence of “downside guarantees” in a variable annuity (e.g.: Guaranteed Minimum Withdrawal and/or Income Benefits) enable a highly risk-averse investor to be comfortable in allocating more of his account to *equities* than he would otherwise be willing to do, thus providing that investor with greater potential gain than a lower risk/lower return allocation could be expected to produce, the annual cost of those downside guarantees might reasonably be weighed against the expected increase in return.

SOME OBSERVATIONS ON APPROPRIATENESS OF ANNUITIES

As we have observed, an annuity – any annuity – is a tool, a device intended to accomplish a particular job. How well a particular annuity will do that, relative to how well one or more specified alternatives would, depends upon (a) the job and (b) the specific type of annuity being considered. While sweeping generalizations should be avoided, it is possible to make some general observations about when annuities generally perform well and when they do not. Indeed, in the author’s opinion, it is possible to assert a few “bright line tests” with regard to the appropriateness or inappropriateness of annuities in specific situations. In the following discussion, we’ll examine some of the most common *goal situations* and how well – or poorly – annuities may work in those situations. Where a particular type of annuity is clearly suitable or unsuitable, the author will suggest suitability rules (“bright line tests”) that will appear in ***bold italics***.

Where The Goal Is *Immediate Income*

When *immediate income* is the primary goal, an *immediate annuity* may be appropriate, *provided that there is no requirement that principal be preserved.* As an immediate annuity consists of the amortized distribution of both earnings and principal, it is not appropriate when all, *or even some*, of the amount invested *must* remain at the end of the income period. A *deferred annuity* is not designed to produce income immediately. Indeed, many deferred annuities do not permit distributions during the first contract year. Those contracts that do permit distributions in the first year generally limit such distributions to contract gain.

If any principal must remain after the income has been distributed, an immediate annuity is inappropriate.

If income must commence within a year of the investment, a deferred annuity is inappropriate.

Where The Income Amount Must Be As High As Possible On A Guaranteed Basis

Where the primary goal is income and where the amount of that income must be as high as possible *on a guaranteed basis*, an immediate annuity is ideal. The key word, here, is *guaranteed.* Where the income period is a fixed number of years, a *Period Certain* fixed immediate annuity will generally provide a greater amount than can be *assured* from any investment alternative because the non-annuity alternative must preserve principal. Where the income period is for the entire lifetime of the recipient *and* where no part of principal must remain at the expiry of that period *and* where the amount of each income payment must be assured in advance and be as high as possible, an immediate annuity is not only the most appropriate solution, but also the *only* solution.

This is true not only when the amount of each payment must be the same, but also when the amount of each year's payment must increase, by either a fixed percentage or by an index such as the Consumer Price index (CPI). It should be noted that not all immediate annuities offer such an increasing amount option and that very few offer increases tied to an external index such as the CPI.

Where the amount of income payments must be guaranteed in advance and where no principal must remain, an immediate annuity is the ideal solution.

Where the Goal Is Accumulation of Capital

Where the goal is capital accumulation, an immediate annuity is clearly not suitable, but a deferred annuity *may* be. If *preservation of principal* is a requirement, a fixed deferred annuity might be appropriate, but a variable one, *in the absence of a "Guaranteed Minimum AccumulationBenefit" rider*[3], is not. This is because a variable annuity, except to the extent that its cash value is invested in the "fixed account", does not offer safety of principal.

With the addition of this "rider" (or, if the purchaser is willing to consider a return of purchase payments *in installments* as a "guarantee of principal", a *Guaranteed Minimum Withdrawal Benefit ["GMWB"]*), a variable deferred annuity can serve as an instrument for capital accumulation with "safety of principal". Indeed, the GMWB provision of many contracts includes a "step up" feature that not only assures the return of the original investment (in installments), but also any contract gain accrued as of the point where the "step up" option may be exercised.

If safety of principal is not required (or if the riders described have been added), a variable annuity is certainly an instrument for capital accumulation. Whether it's the *right* instrument depends upon several factors.

Where *All* That Is Wanted Is Capital Accumulation

Where the goal is purely accumulation of capital, with no concern for assuring a minimum income later on or for a guaranteed minimum death benefit, a fixed deferred annuity may be appropriate, but, in the author's opinion, a variable annuity is probably not. This is because the ongoing contract charges (notably, the "Mortality and Expense" charge) in these contracts, that pay for the *annuity payout* guarantees and the standard Minimum Death Benefit guarantee they contain, would, in this scenario, be all, or nearly all, "overhead cost". The average "M&E" cost in today's variable deferred annuities is, according to *Morningstar, Inc.*, approximately 1.2% of the account balance[4]. This is a significant amount to be paying, each year, for benefits one does not particularly want. By contrast, fixed deferred annuities contain no such contract charges. They offer the same annuity payout guarantees, however, and they charge for them. However, in the case of fixed contracts, the cost for these payout options is paid from the "interest rate spread" – the difference between what the issuing insurer earns and what it credits to contract holders[5]. This allows a *direct* comparison of the crediting rate offered by the fixed annuity with that of alternatives such as CDs.

All variable deferred annuities offer a "fixed account", and many advisors recommend allocating a portion of the client's money to them. There are two advantages to this strategy, in addition to the obvious diversification advantage. First, holding a portion of one's annuity money in a fixed account guarantees both safety of principal and a minimum interest rate with respect to that portion. Second, M&E charges and any optional "rider" charges are assessed only against the value of *separate* (non-fixed) accounts. But it should be noted that the *current* interest rate of the fixed account in many variable annuities is less than the current interest rate offered by the same insurer in its *fixed* deferred annuities. Funding a variable annuity entirely with the fixed account may be less attractive than simply buying a fixed annuity.
With regard to comparisons, it should be noted that, in variable contracts, the *net* return available to the purchaser is the *gross* rate earned by the underlying investments, less the operating costs at the "investment sub-account" level (comparable to the "expense ratio" of mutual funds), *less the contractual charges.* If one assumes (for purposes of comparison) that the gross return on a portfolio of VA sub accounts is the same as that of a comparable portfolio of mutual funds, the annuity imposes an additional level of costs, which inevitably results in a lower *net* return in the annuity.

Is this to say that this additional level of costs is *excessive*, or even *unnecessary?* If the benefits that these additional costs pay for are not desired (that is, that the investor does not value the annuity guarantees), then the answer, in the author's opinion, is "yes". Of course, not all investors consider annuity and minimum death benefit guarantees to be meaningless. For those who do, however, a "bright line test" emerges with regard to variable deferred annuities that do not include "Guaranteed Living Benefits":

Where the minimum death benefit and annuity payout guarantees are not important to the investor, a variable deferred annuity with no "guaranteed living benefits" is probably not appropriate.

But what about those investors who wish the "upside potential" of returns possible from a portfolio of *equity* (or *equity and bond*) investments, but with some "downside guarantees"? That's where the newer "Guaranteed Living Benefits", available in newer variable deferred annuity contracts, can be very attractive.

Where The Goal Is "Market-like" Returns With "Downside Guarantees"

Amounts invested in the "separate accounts" of a variable deferred annuity[6] enjoy neither safety of principal nor a guaranteed minimum return. The value of these accounts varies directly with the performance of the underlying investments chosen. The purchaser assumes the *investment risk* inherent in these accounts, in exchange for the potential *reward* associated with such holdings. Many investors want and need the *returns* possible when their money is "in the markets", but are unwilling to assume all the *risks* commensurate with that choice. To satisfy these investors, issuers of variable deferred annuities have developed optional "riders" to their contracts, the so-called *Guaranteed Living Benefits*. Currently, there are four types of Guaranteed Living Benefits:

1. *Guaranteed Minimum Income Benefit (GMIB)*
2. *Guaranteed Minimum Accumulation Benefit (GMAB)*
3. *Guaranteed Minimum Withdrawal Benefit (GMWB)*
4. *"Combination" Riders, employing features of two or more of the first three provisions.*

A thorough description of these riders is beyond the scope of this article. (An extensive discussion of these and other annuity provisions may be found in *The Annuity Advisor* (National Underwriter Co., 2005), by the author and Michael E. Kitces, MSFS, CFP®, CLU, ChFC). That said, one can make a general observation:, The essence of all Guaranteed Living Benefits (GLBs) is that they provide the purchaser with protection against "downside risk" (the possibility of *losing money*, due to poor investment performance). Each GLB operates differently, and some assure, not only a recovery of principal, but of principal and a stated minimum return.

The appeal of a variable deferred annuity containing a Guaranteed Living Benefit is simple: The purchaser gets the "upside potential" associated with the types of investments selected, with *insurance* against loss[7]. This makes for an attractive package – so attractive that it is sometimes marketed as "the best of all possible worlds", "the perfect retirement planning instrument", or the like.

That, in the author's opinion, is going altogether too far. For one thing, a variable deferred annuity where a Guaranteed Living Benefit has been elected is *expensive.* A typical deferred variable annuity with such benefit has a total *annual expense* approaching 300 basis points (3%) per year. GLBs are generally available only in fully commissionable contracts.

The most common Mortality, Expense, and Administration (ME&A) charge in such contracts is 1.4% per year. In addition, the purchase must pay the annual expenses of the investment accounts selected, which might add an additional 1%. While the cost of GLBs varies considerably, the range is roughly 25-75 bps/year (0.25% - 0.75%). The "Combination Rider" from several insurers costs 60 bps/year (0.6%). It is arguable that the insurance that these Guaranteed Living Benefits provide is not worth the price charged (and the same may be said of the "enhanced" Guaranteed *Death* Benefits in many of today's contracts).

Whether the *benefits* conferred by these provisions are worth the *price* charged is surely a matter for individual decision. Some investors will value these guarantees more highly than others. In addition (in the author's opinion, at least), the decision is not entirely a mathematical one, for two reasons:

First, because *quantifying* the risks transferred from the purchaser to the insurer by these riders is a daunting, if not impossible, task. There are many variables involved. Moreover,, the data from which one might make a determination is not available to most of us.

Second (and perhaps more important), quantification is difficult because the *benefits* conferred are not wholly financial. There is surely an *emotional* component. Will the investor *sleep better*, given such guarantees? If so, how important is that?

A test that might be useful in this regard is: *Would the investor rather have a hypothetical average return of X%, with no assurance of any minimum or of a certain future value or annual annuity payment, or that same average return, less YYY basis points per year, for the assurance of a certain future value or annual annuity payment* ***if things go wrong?***

The technical reader will object that this test is hardly mathematically rigorous, and will be right in doing so. It is not. But it may help an investor in assessing his or her real *risk tolerance.*

Commissionable vs. Non-Commissionable Variable Annuities

Some variable annuities assess no surrender charges. Some of these assess M&E charges at or near the levels for "regular" commissionable VAs and pay reduced sales commissions or assess higher-than-usual M&E and pay normal sales commissions. Guaranteed living benefits are usually offered in these contracts. Others offer far lower M&E charges and pay no sales commissions. Usually, these contracts do not offer guaranteed living benefits (or "enhanced" guaranteed death benefits).

What can we make of these facts? First, that surrender and M&E charges are the source of selling commissions. The so-called "low load"[8] contracts out there were designed to be sold directly to consumers or for recommendation by fee-compensated advisors.

While some offer few investment choices[9], others feature many accounts from a variety of money managers. All, however, emphasize *low cost*.

Why don't these contracts offer guaranteed living benefits or "enhanced" death benefits (at optional extra costs)? One reason is that low cost is a market niche and that marketing low cost is much easier when your cost structure is both low and simple (with no "at additional cost" items). Another may be that the issuers' actuaries are not confident that they can price such benefits properly. Whatever the rationale(s), the result is a choice. One can buy a "basic" annuity, with low annual costs and no surrender charges, but no optional living or death benefits, or a "fully loaded" annuity, with optional "riders" and possibly more investment choices, but assessing higher annual costs and surrender charges. Of course, the consumer is not likely to get a recommendation for the former from an advisor whose income comes from commissions or for the latter from a "fee only" advisor. But this condition is not unique to annuities. It has existed since at least the emergence of "no load" mutual funds.

Where The Goal Is Income Later On

Where the goal is an income (perhaps an income for life) to commence *later on*, a deferred annuity, either fixed or variable, may be appropriate. *All* deferred annuities contain *guaranteed payout factors* that specify how much income the contract owner will receive, *regardless of future changes in life expectancy or interest rates*, per dollar of contract value placed under that payout option.

Is this a valuable guarantee? If one looks to the past, it would not seem so. To the author's knowledge, there has never been a time, in the 33 years that he has been selling insurance and annuities, when the payout factors *guaranteed* in *any* deferred annuity contract were as attractive as the payout factors then available in the *immediate annuity* marketplace. Indeed, this is the chief reason why so few deferred annuities are ever annuitized. One has always been able to "go shopping" for payout rates, and, finding an immediate annuity with better payout rates, exchange one's deferred annuity for that immediate one, in a tax-free exchange, under IRC §1035.

That said, the longevity of Americans is increasing, and at an increasing rate. Is it possible that the payout rates *guaranteed* in todays deferred annuities might be better than the *current* rates of immediate annuities decades from now, when average life expectancy may be far greater? Is that possibility worth *insuring?* Moreover, suppose that one assumes that future current rates will be more attractive than today's guaranteed ones and chooses some vehicle other than a deferred annuity to *accumulate* capital, intending to invest that accumulated capital, later, in an immediate annuity (to take advantage of those higher payout rates)? Will not the untaxed gain be taxed at that point, resulting in less money placed under the payout option?

Where an *assurance* of a *future* income stream is important, guaranteed annuity payout factors might not be seen as important. Guaranteed Living Benefits, on the other hand, very likely will be. Not only do such provisions rely on payout factors *guaranteed,* but those factors will be applied to a future account balance that is sure to be *at least as great* as the minimum specified in the benefit, *even if future investment performance is poor.* The assurances that these GLBs provide have proven very attractive to many investors. But it is very important to understand that these provisions are not designed to enhance returns, but to control loss. In fact, their annual cost reduces returns credited – which leads us to yet another "bright line test":

"Guaranteed Living Benefits" are appropriate when the investor is willing to trade a part of each year's return for guarantees against investment loss.

Where The Goal Is To Achieve Tax Benefits

One of the most exasperating aspects of the debate over the value of deferred annuities is the extent to which participants on both sides make rash assumptions about the income tax benefits they provide – or are claimed to provide.

Tax Arguments Offered By Annuity Proponents

Those who market these contracts have, for years, touted the fact that "gain" in a deferred annuity enjoys *income tax deferral*[10], often without even discussing the inescapable trade-offs of such treatment – namely, that –

1. Under current tax law, all distributions from annuities are taxed as Ordinary Income. They never qualify for Capital Gains treatment.
2. Early distributions from annuities are subject to a 10% penalty tax, to the extent of "gain", unless an exception to the penalty applies.
3. *Tax deferred* does not mean *tax free.* Not only will the owner inevitably pay tax on the contract gain, but so will the beneficiary (as "Income In Respect Of A Decedent").

Does the benefit of tax deferral outweigh these drawbacks? In the author's experience (which includes having done many analyses of this very question for consulting clients), the answer can be nothing more than "It depends". There are numerous variables involved, and the impact of each on the overall result is not the same in every fact situation. However, the author believes that a few generalizations can be made when comparing a deferred annuity to a currently taxable investment alternative:

1. The higher the investor's current – and, especially, future – tax bracket, the better a deferred annuity will perform (by comparison)[11].
2. The higher the portfolio *turnover rate* in the taxable alternative, the better the annuity will perform.
3. The higher the annual expense charge of the annuity (or, viewed another way, the lower the annual expense of the taxable alternative), the worse the annuity will perform.

4. The longer the accumulation period (from the initial investment until the investor begins receiving income), the better the annuity will perform.
5. The longer the distribution period (over which income will be received), the better the annuity will perform. In hundreds of analyses, the author found this variable to have the greatest impact on the final result (of whether the annuity or investment alternative produced the greatest net return).
6. If a major planning goal is to leave the money under consideration to *heirs*, a deferred annuity is generally a poor choice, because all contract gain will be taxed to that beneficiary as Ordinary Income and the entire annuity value will be includible in the investor's estate, for death tax purposes, with no "step up in basis"[12].

Tax Arguments Offered By Annuity Opponents

A frequent criticism of deferred annuities (usually, but not always, deferred variable annuities) is that they should not be used to fund IRAs or qualified plans. There is no point to doing so, the argument goes, because it "wastes" the tax deferral enjoyed by annuities, because all IRAs and qualified plans get such treatment anyway. Occasionally, one hears the further criticism that such a strategy means "you're paying for tax deferral you're not getting". This is sheer nonsense. *No* annuity imposes *any* charge for tax-deferral. (Whether the charges deferred annuities do impose are worth the benefits the investor gets is a legitimate question, but no purchaser of *any* deferred annuity pays a cent for tax deferral).

The argument that an IRA owner investing in an annuity "wastes" the tax deferral conferred by annuities is not so specious, but it's still nonsense because the "regular annuity rules" of IRC §72 that grant (by implication) tax deferral of undistributed gain to annuity contracts *do not apply* to annuities that fund IRAs or qualified plans. The fundamental flaw of the "wasted deferral" argument is its implicit assumption that the tax treatment that would apply to a particular investment, if held in a "regular" account, is somehow relevant when that same investment is held in a "qualified" account.

A simple example will illustrate the folly of this assumption. If one owns shares of a "small cap growth" stock, or a fund investing in such stocks, and holds those shares for more than one year, one can expect all, or nearly all, gain to be taxed at preferential Long Term Capital Gains rates. But if one holds the same shares in a traditional IRA or qualified plan, those gains, *whenever distributed*, will be taxed at higher Ordinary Income rates. Would any reasonable person conclude from these facts that one should never hold "small cap growth" assets in an IRA or qualified plan because doing so would "waste" the LTCG treatment they would otherwise enjoy? Of course not. Such a conclusion would be foolish - and it is no less foolish when applied to annuities.

Conclusion

The current state of debate about annuities is unfortunate, both for advisors (who are often presented with "educational" materials that are largely polemic) and for consumers (who can hardly be blamed for being confused as to how and when annuities can be appropriate for them – and when and why they might not). Too often, the discussion proceeds from false or shaky assumptions, such as that the M&E charge in a variable annuity is an *investment* expense, rather than what it is (an *insurance* charge for a *risk management* benefit), or that tax deferral is always desirable (even when it requires forfeiting capital gains treatment and a "step up in basis" for beneficiaries).

Even worse than the questionable assumptions is the tendency of many commentators to treat all annuities as though they're more or less alike. In fact, deferred annuities and immediate annuities are very different and are designed to do very different jobs. Similarly, to speak of "annuity costs" as though they apply equally to both fixed and variable contracts is meaningless; variable and "equity index" contracts contain charges and limits on gain that do not appear in traditional fixed annuities.

Advisors who offer counsel about annuities need to understand how the various contract types differ and when and how each type can be appropriate. Key to this understanding is a recognition that an annuity, in its most basic sense, is about *income.* This is obvious when the annuity is an immediate one, but it is also true of deferred contracts. The *guarantees* of *minimum income* that are contained in *every* annuity are part of the bundle of benefits the purchaser gets – and part of the annuity's *cost*. If an *assurance* of a *known income* for a *known* period (including one's entire lifetime) is not of concern to the client, the prudent advisor should question whether *any* deferred annuity is appropriate. It may be. The so-called "CD annuities" that offer multi-year interest guarantees (often, for a period extending to the end of the surrender charge period) might well be viewed solely as a *savings* vehicle, comparable to a Certificate of Deposit.

Most deferred annuities, however, are long term instruments. When viewed solely from the standpoint of their ability to produce *capital accumulation*, they suffer from a significant disadvantage, relative to alternatives (such as mutual funds): All distributions will be taxed as Ordinary Income. On the other hand, they enjoy tax deferral. Whether this trade-off will prove advantageous or not to an investor depends upon several factors, the most important of which is Time. The longer the holding period, all other things being equal, the better an annuity will perform, compared to a taxable alternative. If the holding period contains not only a number of years of *accumulation*, but also a period of *distribution*, the annuity often compares favorably to taxable alternatives. And where distributions must persist for the investor's entire lifetime, the annuity really comes into its own. Not only does an extended distribution period increase the benefits of tax deferral[13], but it brings into play the defining element of any annuity – the *guarantee* that payments will be made as scheduled, *regardless of future changes in interest rates or life expectancy.*

Annuities are all about *income.* If an investor wants and needs *guaranteed income*, an annuity is often a suitable (and sometimes ideal) choice. If he or she does not, its suitability is at least questionable.

Endnotes

---

[1] It is sometimes argued that a particular type of annuity (e.g.: a traditional fixed annuity or an "index annuity") is more a *savings* instrument than an *investment* one. That may be true, but, in the author's opinion, the distinction is not really germane to the issues considered in this article, for which reason, it will not be addressed here.

[2] The author concedes that fixed deferred annuities, especially those short-term contracts designed and marketed to compete directly with Certificates of Deposit, could be considered purely "investments" when the purchaser is interested only in the interest rate offered and the deferral of tax liability.

[3]The *Guaranteed Minimum Accumulation Benefit (GMAB) rider guarantees at least the original principal (and, in some provisions, a minimum return on that principal) at the end of a specified waiting period.*.

[4] This average figure considers both commissionable and non-commissionable contracts. The average charge for commissionable contracts is higher. The most common annual contract charge, in the author's experience, is 1.4%.

[5] The death benefit guaranteed in most fixed deferred annuities is the account balance. There is generally no separate death benefit guarantee, because the guarantee of principal makes one unnecessary.

[6] "Separate accounts" (sometimes termed "investment sub-accounts") are invested in pooled equity and/or bond accounts the value of which can, and usually does, change daily. *There is no Safety of Principal or Minimum Guaranteed Return in such accounts.* Amounts invested in the "fixed account" of such contracts are invested in the General Account of the issuing insurer and do enjoy guarantees, both of principal and of a minimum interest rate.

[7] It is important to note that only two GLBs guarantee a future *lump sum* value (the GMAB and the "Combination Rider"). The GMIB and GMWB guarantee future values, but only if taken in *installments.*

[8] "No-load annuity" is a misnomer. *All* annuities assess some "loads".

[9] For example, T. Rowe Price's VA offers only investment accounts managed by T. Rowe Price; Vanguard's VA offers only Vanguard accounts.

[10] This is true only when the annuity is owned by a "natural person" (IRC §72(u)) or an entity acting as the "agent of a natural person" (IRC §72(u)(1)).

[11] Obviously, the 10% penalty tax (IRC §72(q)), if imposed, will have a significant adverse effect on the annuity's *net* performance. However, if it assumed that distributions will commence after the investors' age 59 ½ and/or be taken over the remaining lifetime of the investor, the exceptions to that penalty offered by IRC §72(q)(2)(A) and/or 72(q)(2)(D) are available.

[12] The presence of a Guaranteed Death Benefit (especially if the investor was not insurable at standard rates) would mitigate this general disadvantage of the deferred annuity.

[13] Accumulated contract "gain" in an annuitized deferred annuity is not taxed on a "last in, first out" basis (as is the case with "amounts not received as an annuity"); rather, recognition, and tax, of such gain is amortized over the recipient's lifetime.