

Contract Requirements and Prior Regulatory Approval

Annuity contracts and related forms generally must be filed and approved in every state where they will be sold. While there is no standard required form for annuity contracts, states mandate that certain provisions be included in all contracts, such as a free-look provision that allows a contract owner to examine the contract for a period of time and return it for a refund if dissatisfied for any reason. Generally, contracts need to be readable and cover all of the contract's basic features before the state will approve the contract for sale. Amendments to contracts also must be filed and approved. If the amendment could adversely affect existing contract owners' rights, the state may require prior approval from the contract owners.

State Guarantee Funds

All states, the District of Columbia, and Puerto Rico have guarantee funds to protect contract owners against insurance company insolvency. Insurers doing business in a state must contribute to that state's guarantee fund. The actual coverage provided for annuity contracts varies from state to state, but cash values and annuity benefits generally are protected for at least \$100,000. Coverage is not provided for variable annuity contracts (other than assets invested in the fixed account option under a variable annuity contract). However, as discussed below, variable annuity contracts are issued through life insurance company separate accounts, which are insulated from the general creditors of the insurance company in the event of insolvency.

Variable Annuity Asset Protection

When a contract owner allocates purchase payments to a variable investment option under a variable annuity contract, those assets are held in a separate account of the insurer. The assets in the separate account are insulated against the creditors of the insurance company in the event of the company's insolvency. In some states, annuity assets are shielded from a contract owner's creditors as well.

Advertising and Unfair Trade Practices Rules

Most states have adopted advertising rules governing the marketing of annuity contracts. State insurance departments review advertising materials periodically. Advertising rules are designed to prevent misleading, deceptive, or confusing advertisements, as measured against the impression a person who is not knowledgeable in insurance matters may receive from the materials.

All states have adopted unfair trade practices acts with provisions that apply to an insurer's activities. These laws define and prohibit unfair methods of competition and unfair or deceptive business practices, including those involved with the issuance, sale, and administration of annuity contracts.

Over forty (40) states have adopted a requirement that sales of annuities must be suitable given a customer's financial status and objectives, and most of those 40 states explicitly require companies to maintain a reasonably designed compliance system providing reasonable assurance of compliance with the suitability law.

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is an association that promotes fairness and uniformity in state insurance laws. It has developed numerous “model laws” and “model regulations” that have been adopted in one form or another by many states.

REGULATION UNDER THE FEDERAL SECURITIES LAWS

Introduction

Besides being governed by the state regulatory framework, absent an exemption, variable annuities as securities are regulated under federal securities laws. The primary federal securities laws that regulate variable annuities and the separate accounts through which they are issued are the Securities Act of 1933 (1933 Act), the Securities Exchange Act of 1934 (1934 Act), and the Investment Company Act of 1940 (1940 Act). The SEC administers these acts. Fixed annuities, where the insurance company guarantees a specific rate of return to the contract owner, generally are not subject to these laws. Under a new rule adopted by the SEC, payments to the purchaser are dependent on the performance of a securities index, and will become subject to federal securities laws. (This rule is being challenged in court; as of the date of the publication of this Fact Book, this challenge was still being adjudicated.)

In summary, the federal securities laws require certain disclosure documents, including a prospectus, to be given to investors. Certain disclosure documents must also be filed with the SEC. In addition, written marketing materials such as advertisements are subject to regulation under SEC and FINRA rules. Certain periodic reports must be filed with the SEC and delivered to investors. These requirements are discussed in more detail on the following pages.

Securities Act of 1933

Contract Registration

Because variable annuities are securities, they must be registered with the SEC under the 1933 Act before they can be offered to the public (with two exceptions noted below). The SEC staff reviews and comments on registration statements, which usually must be amended in response to staff comments before they will be declared effective. (The SEC does not, however, approve or disapprove of any securities, including variable annuities, and does not pass on the accuracy or adequacy of any

prospectus.) A “post-effective” amendment updating the variable annuities registration statement generally must be filed at least annually.

The first registration exception is for variable annuity contracts that are issued in connection with certain qualified plans such as 401(k) plans. The second exception is for private placement variable annuities, which are contracts that, among other things, are offered only to sophisticated investors who meet certain requirements under the federal securities laws (and not to members of the general public). Even with these exceptions, however, issuers and others involved in marketing non-registered variable annuities, remain subject to the anti-fraud provisions of the 1933 Act.

Prospectus Delivery

When someone purchases a registered variable annuity, he or she receives a prospectus. Prospectuses are updated regularly. Separate prospectuses describe underlying investment options—the funds to which the purchaser may allocate his or her investments. This can result in a purchaser receiving numerous prospectuses. However, the SEC recently adopted a rule permitting the delivery of an annuities underlying fund, “summary prospectuses,” which are shorter, and intended to be more “user-friendly” than full fund prospectuses.

Disclosure of Fees and Expenses

Variable annuity prospectuses contain fee tables that disclose the maximum guaranteed charge for all contract transaction expenses and recurring charges. These amounts are expressed in dollars or percentages of the contract value so purchasers will know what they will pay if they buy the contract. The fee tables also list the range of total operating expenses for all of the underlying funds offered by the contract. In addition, variable annuity prospectuses contain numerical examples showing in dollars per \$10,000 what a contract owner would pay for the contract and the maximum fees and expenses charged by any of the funds over one-, three-, five-, and ten-year periods. These examples assume a 5% return and that the contract is surrendered at the end of the relevant period. Additional examples are required that assume the investor does not surrender the contract if a sales load or other fee is charged upon surrender. This format shows the effect of any surrender charge.

Securities Exchange Act of 1934

The 1934 Act generally requires variable annuities to be distributed through registered broker-dealer firms and their registered representatives. Broker-dealers and their representatives are subject to extensive operational and financial rules that cover minimum net capital requirements, reporting, recordkeeping, supervision, advertising, and sales activities.

In addition to the broker-dealer regulatory framework established by the 1934 Act, registered broker-dealer firms that sell variable annuities also must be members of FINRA. FINRA is a self-regulatory organization overseen by the SEC. It has an

extensive body of rules with which broker-dealers must comply. For example, examinations are required, fingerprints must be provided and numerous supervisory, suitability, advertising, recordkeeping, and reporting rules apply.

A 1934 Act rule requires broker-dealers to send confirmation statements to contract owners after each purchase and sale transaction made involving a variable annuity contract. In addition, insurance companies send contract owners periodic account statements showing a beginning balance, transactions during the period, and an ending balance so that the owner will have a record of all activity in his or her contract.

Investment Company Act of 1940

The 1940 Act imposes an extensive federal regulatory structure on investment companies, including variable annuity separate accounts and underlying funds. (Some separate accounts and funds such as those used in connection with tax-qualified retirement plans, are not subject to the 1940 Act.) For example, the Act governs how variable annuities and shares of underlying funds are issued and redeemed. There are also corporate governance requirements and prohibitions against self-dealing.

Each separate account regulated under the 1940 Act must file a report on its operations annually with the SEC. In addition, an annual and semi-annual report containing information about the underlying mutual funds that serve as investment options for the variable annuities must be sent to contract owners. In some cases, these reports also contain information on the variable annuities themselves.

The SEC inspects variable annuity separate account operations regularly. The SEC also inspects various locations, such as broker-dealer offices, from which variable annuities are sold. Recommendations are made and any deficiencies are noted. If the situation is serious enough, it is referred to the SEC's enforcement division.

Regulation of Fees and Charges

Currently, the SEC does not regulate individual variable annuity fees and charges. However, the 1940 Act makes it unlawful for any registered separate account funding variable annuity contracts, or for the sponsoring insurance company, to sell any such contract unless the fees and charges deducted under the contract are, in the aggregate, reasonable in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company. The insurer must represent in the annuity contract's registration statement that the fees and charges are reasonable.

SEC and FINRA Advertising Rules

SEC Rules

SEC rules govern variable annuity advertising. If past performance of a fund or variable annuity is presented, performance must be calculated according to standardized

formulas. “Non-standardized” performance may also be shown, but must be presented along with standardized performance. In addition, if an advertisement contains performance information, total returns current to the most recent month end must be made available within seven business days of the end of the month at a toll-free or collect telephone number or on a website.

FINRA Rules

In addition to the SEC rules, FINRA rules also govern variable annuity advertisements. Broker-dealer firms that disseminate variable annuity advertising must file these communications with FINRA and take into account comments provided by FINRA staff.

Recent Regulatory Action

There are several regulatory initiatives that have been adopted or are pending that affect or could potentially affect the sale of variable annuities.

In early 2009, the SEC adopted new rules to enhance the disclosures that are provided to mutual fund investors. The new rules require key information to appear in plain English in a standardized order at the front of every mutual fund prospectus. The SEC also adopted a new rule permitting funds to satisfy their prospectus delivery obligations by sending or giving the key information directly to investors in the form of a summary prospectus, so long as the full prospectus is provided on an Internet Web site. Upon an investor’s request, funds are also required to send the full prospectus to the investor. These amendments are intended to improve mutual fund disclosure by providing investors with key information in plain English in a clear and concise format, while adopting a “layered” disclosure approach to enhance the means of delivering more detailed information to investors. The new rules will be phased in over several years, and while variable annuity purchasers will undoubtedly benefit from more user-friendly underlying fund summary prospectuses, it is unclear exactly how and the extent to which insurance companies and underlying funds will be able to coordinate to offer investors such summary prospectuses.

Deferred Variable Annuity Transactions

In 2008, a new variable annuity sales practice rule, FINRA Rule 2821, went into effect. Rule 2821 imposes a wide range of new requirements tailored specifically to deferred variable annuity transactions, including suitability, principal review, supervision, and training (The principal review and supervision requirements go into effect in early 2010). The rule provides that, in recommending a deferred variable annuity, a registered representative must have a reasonable basis to believe that (a) the customer has been informed in general terms of various features of a deferred variable annuity; (b) the customer would benefit from certain features of deferred variable annuities, such as deferred growth, annuitization, or a death or living benefit; and (c) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated, and riders and product enhancements, if any, are suitable for the particular customer based on required customer information.

Fixed Indexed Annuities

In 2008, the SEC adopted a new rule, Rule 151A, that is intended to clarify the status under the federal securities laws, payments to the purchaser are dependent on the performance of a securities index. The rule applies on a prospective basis to contracts issued on or after January 12, 2011, and subjects indexed annuities to many of the same requirements applicable under the federal securities laws to variable annuity contracts (The rule has been challenged in a lawsuit, and as of the date of publication of this Fact Book, the outcome of the challenge was uncertain).

TAXATION OF ANNUITIES

This section explains the federal income taxation of annuities. The focus is on annuities that are not part of a qualified plan, although the basic differences between qualified and non-qualified annuities are discussed. State taxes and federal estate and gift taxes are not discussed; however, these taxes may also affect annuity owners.

Premiums

If an annuity contract is part of a qualified plan, premiums are plan contributions and generally not includible in the employee's income when paid. However, if an annuity is used in a "Roth" type of arrangement, such as a Roth 403(b) annuity, the premiums are includible in income. For a non-qualified annuity, premiums are paid with after-tax monies and are not tax deductible.

Tax Deferral

Dividends, interest, and capital gains credited to an annuity are not taxed until they are withdrawn. In other words, earnings are tax deferred and reinvested to help accumulate assets for retirement. As a result, money may be transferred from one investment option to another inside a variable annuity without incurring a tax liability. This is not true for taxable investments, where transferring amounts from one investment to another, such as from one mutual fund to another, will be treated as a sale and any gains will be taxable.

If a deferred annuity contract is not owned by an individual, but rather by an entity such as a corporation, the contract is not eligible for tax deferral in most cases. Rather, the entity is taxed each year on the increase in the net surrender value of the contract, minus premiums paid during the year (Special rules allow certain trusts to own an annuity and still be eligible for tax deferral). Congress enacted this requirement to ensure that the tax deferral granted by annuities is used primarily as a vehicle for individuals' retirement savings.

Withdrawals

When a contract owner begins to receive money from an annuity, distributions taken in excess of the amount invested are subject to taxation at the owner's ordinary income tax rate. Just as with IRAs, 401(k) plans, and other tax-qualified plans, when money is withdrawn, it does not receive favorable capital gains treatment. As discussed below, however, annuity income payments receive more favorable tax treatment than lump sum payments or withdrawals. Also, unlike qualified plans, income payments under a non-qualified annuity can be deferred past age 70½ and taken when the need arises.

Because Congress set the rules on tax deferral to encourage long-term retirement savings, withdrawals made before age 59½ may be subject to a 10% federal tax penalty on the taxable amount of earnings withdrawn, in addition to any income taxes due on that amount (There are exceptions to the 10% penalty). This is similar to the 10% penalty tax on premature distributions from IRAs and underscores the fact that annuities are designed to be long-term retirement vehicles (There also may be surrender charges, as discussed in Chapter 1, if the withdrawal exceeds any annual free-withdrawal amount or the surrender charge period has not run out. Surrender charges are imposed by the terms of the contract and should not be confused with the 10% federal tax penalty).

For most contracts, the tax rule on withdrawals is "interest and earnings first." Under this rule, interest and earnings are considered withdrawn first for federal income tax purposes. For example, if someone invested \$25,000 in a fixed or variable annuity and the contract is now worth \$45,000, the first \$20,000 withdrawn is taxable. The remaining \$25,000 is not taxed because it is considered a return of principal. Withdrawals are taxed until all interest and earnings are withdrawn; the principal then can be withdrawn without tax.

The "interest and earnings first" rule is intended to encourage the use of annuities for long-term savings and retirement plans. Congress decided that the advantage of tax deferral should not be accompanied by the ability to withdraw principal first, with no tax payable until all principal is withdrawn.

Complete Surrenders

When an owner surrenders an annuity contract, the difference between the amount received and the owner's investment in the contract is taxable. Generally, the investment in the contract is the amount of premiums paid (less any principal that has been previously returned to the contract owner without tax) at the time of distribution.

Gifts and Assignments of Annuity Contracts

If a contract owner gives an annuity contract as a gift, the contract owner may have to pay income tax at the time of the transfer. The contract owner must include in income the difference between the cash surrender value of the contract and the owner's investment in the contract at the time of the transfer. This rule does not apply if the transfer is made between spouses or former spouses as part of a divorce (Gift taxes also may apply).

In addition, any assignment or pledge of (or agreement to assign or pledge) any portion of an annuity contract's cash surrender value is treated as a withdrawal of such amount from the contract. Hence, the tax treatment that normally applies to withdrawals also applies to assignments or pledges of annuity contracts.

Premature Distributions

For non-qualified annuities, a 10% federal tax penalty may apply to the taxable portion of a withdrawal or complete surrender made before age 59½. There are exceptions to the 10% penalty, for example, if the payment is made upon the owner's death or disability. As noted earlier, this penalty is intended to encourage the use of annuities for retirement savings purposes. For that reason, similar penalties generally apply to withdrawals from IRAs and qualified plans, which also are intended for retirement savings.

Taxation of Annuity Payouts

Annuity owners can elect a number of payout options, as discussed in the chapter on *Receiving Retirement Income*. The basic rule for annuity payouts (as distinguished from withdrawals or other non-periodic payments) is that the money a contract owner invests in the contract is returned in equal tax-free installments over the payment period. The remainder of the amount received each year is treated as the earnings on the owner's premiums and is included in income. The income portion is taxed at ordinary income tax rates, not capital gains rates. The total amount that is received tax free can never exceed the premiums the owner paid for the contract.

The taxable portion of each payment is equal to the excess of the payment over the "exclusion amount." With a fixed annuity, the exclusion amount generally is computed by (a) dividing the premiums paid for the annuity by the total expected return from all scheduled annuity payments, and (b) multiplying each payment by this "exclusion ratio." With a variable annuity, because the expected return cannot be predicted, the exclusion amount is generally computed by dividing the premiums paid for the contract by the number of years that payments are expected to be made. For a lifetime annuity, the expected return is always computed by reference to the annuitant's life expectancy as determined using IRS tables.

To illustrate, assume that a male age 65 elects a lifetime annuity and his investment in the contract is \$100,000. Assume further that he has elected to receive annual variable annuity payments and the payment for the first year is \$8,000. Since the payments are variable, they will vary each year thereafter (For simplicity, this illustration assumes annual annuity payments, although monthly or quarterly payments are more common). Applicable IRS tables indicate that such a person is expected to live 20 years. One hundred thousand dollars divided by 20 is \$5,000, which is the portion of each annuity payment that is excluded from income. During the first year, \$5,000 of the \$8,000 will be excluded from income and \$3,000 will be included. The \$5,000 is excluded each year until the total investment in the contract has been received.

Death of an Owner

When an owner of an annuity dies, the general rule is that certain distributions must be made (Similar rules apply to qualified plans). The tax policy behind this rule is to prevent the prolonged deferral of income tax on the gains in an annuity contract that would occur if ownership could be passed from person to person without taxation occurring.

If an owner dies on or after the annuity commencement date, but before the entire interest in the contract has been distributed (for example, if the owner dies five years into a ten-year guaranteed payout term), the remaining portion must be distributed at least as rapidly as under the method of distribution in effect at the time of death.

If an owner dies before the annuity commencement date, the general rule is that the entire interest in the contract must be distributed within five years after the date of the owner's death. Under this rule, a beneficiary has the following choices upon the owner's death:

- Take the amount due under the contract and pay taxes at that time;
- make withdrawals over the course of the next five years and pay taxes on each withdrawal, with the remainder of the contract value growing tax deferred; or
- wait up to five years with the contract value growing tax deferred, then take the entire amount due and pay taxes.

An exception to the five-year rule described above is available for cases where payments are made to a beneficiary over life or life expectancy. Specifically, within 12 months of the owner's death, a beneficiary can (a) annuitize the remaining interest over his or her life or life expectancy and receive the favorable tax treatment accompanying annuity payments, or (b) begin withdrawals over a period not exceeding the beneficiary's life expectancy calculated in a manner specified in IRS rules, and pay taxes on each withdrawal on an income-first basis.

For purposes of the foregoing after-death distribution rules, if an individual is the owner under a contract and the spouse is the beneficiary, then following the owner's

death the surviving spouse is treated as the “owner” of the contract. In such case, the after-death distribution rules take effect upon the surviving spouse’s death, rather than upon the original owner’s death.

Replacement Contracts/1035 Exchanges

When a contract owner purchases a new annuity contract to replace an existing one, the new contract is referred to as a replacement contract. Replacement contracts usually occur in connection with a tax-free exchange of non-qualified contracts under Section 1035 of the Internal Revenue Code, or because of a rollover or direct transfer of a qualified plan contract (for example, an individual retirement annuity) from one life insurance company to another. Annuity owners generally can exchange their annuity contracts for new ones, tax free. In both qualified plans and non-qualified annuities, depending upon the terms of the contract, it also may be possible to transfer, tax free, a portion of the contract to a new contract issued by the same or a different carrier, while continuing the remaining portion of the contract from which the partial transfer was taken. Special rules must be followed to assure that either a complete or a partial exchange or transfer qualifies for tax-free treatment.

The reasons for an exchange of annuity contracts can include:

- The owner has a fixed annuity that has a substantially lower interest rate than other contracts currently available.
- The company that issued the current contract is not as financially strong as it was in the past.
- The new contract may have substantially better features, such as an enhanced death benefit, guaranteed minimum income benefit, portfolio rebalancing, or dollar cost averaging.
- The new contract may have more or better-performing investment options available.
- The new contract may have lower fees and charges.

Many states have passed regulations requiring certain procedures to be followed before an annuity contract is replaced. The contract purchaser and the agent must sign a statement as to whether the contract being purchased will replace an existing one. If so, the new insurance company must promptly notify the old insurance company. The new insurance company must provide the purchaser with a prescribed statement about important factors to consider before buying the replacement contract. In some cases, a surrender charge may be incurred by exchanging the old contract and a new surrender charge period may start on the new contract. For this reason, an individual and his or her financial advisor should carefully evaluate a proposed exchange to ensure that it is in the contract owner’s best interest. States have adopted replacement regulations ensuring full disclosure in these situations and affording other protections. States also may provide longer free-look periods for replacement contracts than for other annuity contracts.

